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TO EXAMINE THE IMPACT OF CURRENT TAX LAWS ON SMALL BUSINESS

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

TO EXAMINE THE IMPACT OF CURRENT TAX LAWS
ON SMALL BUSINESS

SEPTEMBER 13, 1989

Printed for the use of the Committee on Small Business

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TO EXAMINE THE IMPACT OF CURRENT TAX LAWS ON SMALL BUSINESSES

WEDNESDAY, SEPTEMBER 13, 1989

U.S. SENATE,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met at 9:38 a.m., in room 428-A, Russell Senate Office Building, Hon. David L. Boren (Acting Chairman) presiding.

STATEMENT OF HON. DAVID L. BOREN, A U.S. SENATOR FROM THE STATE OF OKLAHOMA

Senator BOREN. I think we will go ahead and commence. There might be some others that will join us—some of the Members of the Committee. If Mr. Swain and Mr. Motley might come forward to the conference table, and we will abbreviate our remarks as much as possible because we know that all of our guests this morning have busy schedules.

I would like to thank Senator Bumpers, the Chairman of the full Committee, for scheduling this hearing to examine the impact of several different tax laws on small businesses.

And I am particularly pleased to have the opportunity to hold further discussions on the problem of estate freezes. I have cosponsored with Senator Daschle S. 849, a bill to repeal Section 2036(c). The Finance Committee, on which I also serve, has previously held general hearings on the need for repeal of this provision. And today we have the opportunity to specifically consider the impact of this unworkable law on small businesses.

Let me touch briefly on a few points which will undoubtedly be focused upon more fully by the witnesses this morning and those submitting testimony. It is clear to me that a compelling case can be made for enactment of this legislation.

First, the current law is overly broad and unintelligible to even the most sophisticated legal counsel, let alone counsel representing many small family owned businesses or farms throughout the United States. Based on our recent experience with the supposed IRS clarifications of Section 89, I do not believe that any forthcoming guidance on this section will clarify the law.

Second, the current law affects many ordinary, day-to-day business transactions that almost everyone would agree should not be covered.

Third, the current law clearly discourages the continuation of family businesses by almost requiring sales to outsiders when an elder family member who is the principle owner passes away.

Fourth, the current law is a vast overkill of what is essentially a valuation question. Surely a more sensible, targeted anti-abuse provision could be developed.

Fifth, this legislation should not lead to excessive revenue loss to the Treasury. The Conference Report to OBRA of 1987 indicated a 3-year revenue gain from what is essentially current law of $109 million. The 1988 legislation supposedly liberalized the 1987 law. I hope this is not a situation where revenue repeal now costs several times more than the revenue gain from the provision which was originally enacted.

This is one of the favorite games that I see played around here, particularly as I view it as a Member of the Finance Committee. Very often when something is attempted and we're working on something where the revenue gain is a certain amount and, lo and behold, if you want to straighten up the mess that has been caused and get rid of the injustice in the tax law, they come around and say, well, but this is going to lose $500 million or $600 million, when their estimate the year before was that it would only gain $100 million by doing it in the first place. So, it is always a mystery to me. It's magic how getting rid of something can lose many times the amount of revenue that putting it in place gained in the first place. But that is the favorite game played by people who manipulate the numbers in order to try to determine policy outcome. And I hope we will not have any of that occur with this particular situation.

I look forward to hearing from our witnesses today and their comments on Section 2036(c), as well as any comments they might have concerning FICA reporting requirements, general payroll taxes, and health insurance deductions for self-employed individuals.

Let me say I welcome all of our witnesses here today. I am very pleased to have a witness from my home State, who also is certainly a longtime friend and adviser and associate of mine, Tom Goodner, who is here representing the National Grocers Association and the Small Business Legislative Counsel. I know several of our witnesses today and am very, very pleased that they are here. We certainly have an outstanding panel of witnesses.

I am pleased also to be joined by my colleague Senator Boschwitz from Minnesota with whom I have worked on many, many projects, both in this Committee and the Agriculture Committee as well, and Senator Wallop from Wyoming who is certainly known as one of those Members of the Senate who has sound views on tax policy. And we have had the privilege of serving together on the Finance Committee for a number of years. So, I am glad to have both of my colleagues with me this morning.

Senator Boschwitz is the Ranking Member of our Subcommittee. Are there any opening comments that you might like to make?

STATEMENT OF HON. RUDY BOSCHWITZ, A U.S. SENATOR FROM THE STATE OF MINNESOTA

Senator BOSCHWITZ. Well, Mr. Chairman, you really said what I was going to say. There is a lot of mystery around here when you fool around with the numbers. When you get down to $109 million,

it shows you how far it has come, that it is almost de minimis. In small business, $109 million is huge business. But in the Federal Government when you are trying to estimate revenues and you say that this is going to raise $109 million in a year, you know that somebody is fooling around and making some approximations.

It would be well to move on 2036(c). It would be well to move on some of the other matters that we have before us.

We have a long list of witnesses, so I'll just put my entire statement in the record.

Senator BOREN. Thank you very much. It will be received in the record.

[The prepared statement of Senator Boschwitz follows:]

STATEMENT OF SENATOR RUDY BOSCHWITZ

FOR THE

SMALL BUSINESS COMMITTEE HEARING ON

SMALL BUSINESS TAXATION

I WOULD LIKE TO BEGIN BY THANKING ALL OF OUR WITNESSES WHO ARE PARTICIPATING HERE THIS MORNING. THE FOCUS OF THIS HEARING, SMALL BUSINESS TAXATION, IS OF INTEREST TO ME BECAUSE OF MY BACKGROUND AS A BUSINESS OWNER. I HOPE THAT THIS MORNING'S TESTIMONY WILL SHED LIGHT ON SOME OF THE PROBLEMS ENCOUNTERED BY SMALL BUSINESS UNDER THE CURRENT INTERNAL REVENUE CODE.

SMALL BUSINESS IS CLEARLY A SIGNIFICANT ECONOMIC FORCE IN THIS COUNTRY. IN THE EARLY 1980S, 64% OF ALL NEW JOBS, 39% OF THE GROSS NATIONAL PRODUCT, AND 55% OF NEW PRODUCT INNOVATIONS WERE CONTRIBUTED BY SMALL BUSINESS CONCERNS EMPLOYING FEWER THAN 500 INDIVIDUALS.

ALTHOUGH SMALL BUSINESS IS ESSENTIAL TO ECONOMIC DEVELOPMENT, IT STILL NEEDS OUR HELP. BURDENSOME TAX AND REGULATORY REQUIRMENTS HAVE THE EFFECT OF RAISING THE COST OF DOING BUSINESS AND CONSUME MUCH NEEDED RESOURCES THAT COULD BE USED FOR NEW PRODUCT DEVELOPMENT OR CAPITAL EXPANSION. SECTION 89 IS THE MOST RECENT EXAMPLE OF SUCH MISGUIDED LEGISLATION.

AS I CONSIDER THE VARIOUS TOPICS WE HOPE TO DISCUSS THIS MORNING, I AM PARTICULARLY PLEASED THAT THE ESTATE FREEZE CONTROVERSY IS ON THE AGENDA. AS ONE OF THE FEW MEMBERS OF CONGRESS WHO IS ALSO A BUSINESS FOUNDER, I CAN EMPATHIZE WITH AN OWNER'S CONCERN THAT HIS BUSINESS REMAIN INTACT AND FAMILY-CONTROLLED UPON HIS PASSING. AS IT STANDS, THAT OUTCOME IS THREATENED BY THE ESTABLISHMENT OF SECTION 2036(C) OF THE 1986 INTERNAL REVENUE CODE.

AS I AM SURE MOST OF YOU ARE AWARE, SECTION 2036(C) MAKES IT EXTREMELY DIFFICULT FOR A FOUNDER TO PASS HIS OR HER BUSINESS ON TO A FAMILY MEMBER WITHOUT FACING EXCESSIVE FEDERAL ESTATE TAXES. I EXPECT THAT THERE WILL BE A TAX BILL THIS YEAR, AND I AM HOPEFUL THAT WE CAN INCLUDE A PROVISION TO SUBSTANTIALLY MODIFY OR REPEAL 2036(C). INDEED, I UNDERSTAND SENATOR BENTSEN IS NO GREAT FAN OF 2036(C) SO PERHAPS WE SHALL SEE SOME MEANINGFUL CHANGES ENACTED THIS YEAR.

I AM EQUALLY PLEASED THAT PAYROLL TAXES IN GENERAL AND UNEMPLOYMENT TAXES IN PARTICULAR WILL BE EXAMINED THIS MORNING, BECAUSE I WILL SOON BE INTRODUCING LEGISLATION TO CORRECT WHAT AMOUNTS TO A TAX ON JOBS.

AS MANY OF YOU KNOW, EMPLOYERS ARE CURRENTLY REQUIRED TO PAY A .8 PERCENT TAX INTO THE FEDERAL UNEMPLOYMENT TRUST FUND. OF THIS AMOUNT, .2 PERCENT REPRESENTS A "TEMPORARY" PAYROLL TAX ASSESSED IN 1976 TO PAY OFF A $8.7 BILLION DEBT INCURRED BY THE

UNEMPLOYMENT TRUST FUND. WHILE THE ORIGINAL STATUTORY LANGUAGE PROVIDED THAT THE TAX WOULD EXPIRE WHEN THE DEFICIT WAS ERASED, WHICH OCCURRED IN 1988, IT REMAINS ON THE BOOKS. I THINK IT IS TIME THE TAX WAS REPEALED.

TO CONCLUDE, I WANT TO WELCOME ALL OF THE WITNESSES HERE THIS MORNING. I LOOK FORWARD TO HEARING YOUR TESTIMONY ON THE IMPORTANT ISSUE OF SMALL BUSINESS TAXATION.

Senator BOREN. Senator Wallop, any opening comments that you would like to make?

STATEMENT OF HON. MALCOLM WALLOP, A U.S. SENATOR FROM THE STATE OF WYOMING

Senator WALLOP. Mr. Chairman, I do, and I would begin by thanking Senator Bumpers and particularly you and Senator Boschwitz for chairing the hearing.

I also really would like to express my appreciation to you both for allowing me to invite two Casper, WY witnesses, Mr. Dave True of the True Companies and Mr. Bob Macy, a CPA, both of whom I welcome here today.

Many of my colleagues know since my early days as a Senator and a former Member of the Finance Committee, I have been involved in the estate tax issue. In fact, legislation that you, Senator Boren, and I sponsored in 1981 allowed gross estates up to $600,000 to be transferred free of inheritance taxes and reduced the maximum rate on the remainder. And we did that with the idea in mind of making small businesses survivable.

Prior to 1988, the estate freezes were the most popular method of transferring ownership in a family owned company to the children while minimizing estate and gift taxes.

In 1987, as part of the work on the budget reconciliation package, Congress severely curtailed this method of estate freezes and included the provision that brings us here today, known as Section 2036(c).

Since the adoption of this provision, a number of my constituents have urged me to work on this onerous and exceedingly complicated section of the tax code. In response to the hue and cry about the section, I cosponsored legislation to repeal it, which is S. 659. And repeal legislation, as you mentioned, David, was the subject of hearings on May 17 in the Senate Finance Committee.

Most people testifying at that hearing expressed their support for total repeal of this section of the tax code. It is now my understanding that in lieu of repeal, an alternative to Section 2036(c) will be included in this year's budget reconciliation bill. I must say to date the proposals for change are basically unsatisfactory.

Wyoming has America's largest number of small businesses per capita. These are family owned and operated, and if our small businesses are taxed in the manner proposed by Section 2036(c), many of these families will be forced to sell all or portions of their business in order to pay estate taxes. I do not believe this was a burden ever intended by Congress, and if it was, it is completely inconsistent with our belief in the free society that is capitalist based.

With that in mind, I sincerely hope that we make the necessary reforms to prevent further erosion of a small businessowner's ability to pass business from one generation to another.

I have other comments, Mr. Chairman, about the self-employment health insurance deduction and the FICA reporting. I ask that those be included in the record.

Senator BOREN. They will be included.

[The prepared statement of Senator Wallop follows:]

STATEMENT BY SENATOR MALCOLM WALLOP
BEFORE THE SENATE COMMITTEE ON SMALL BUSINESS
WEDNESDAY, SEPTEMBER 13, 1989

I begin by thanking Senators Boren and Boschwitz for chairing this hearing. I'd also like to express my appreciation to them for allowing me to invite two Casper, Wyoming witnesses - Dave True of the True Companies and Bob Macy, a CPA -- both of whom I welcome here today. Both these gentlemen have firsthand knowledge of this estate tax issue and I hope the Committee will give them their undivided attention. As many of my colleagues may know, since my early days as a Senator and former member of the Senate Finance Committee, I have been involved in the estate tax issue. In fact, legislation that I sponsored with Senator Boren in 1981 allows gross estates up to $600,000 to be transferred free of inheritance taxes and reduced the maximum rate on the remainder.

Prior to 1988, estate freezes were the most popular method of transferring ownership in a family-owned company to children while minimizing estate and gift taxes. In 1987, as part of its work on the Budget Reconciliation package, Congress severely curtailed this method of estate freezes and included a provision, known as Section 2036(c) of the Internal Revenue Code, which has been very controversial with estate planners and small family-owned businesses.

Since the adoption of this provision, a number of my constituents have urged me to work to change this onerous and complicated section of the tax code. In response to the hue and cry about Section 2036(c), I have cosponsored legislation to repeal it, S. 659. This bill was the subject of hearings on May 17 in the Senate Finance Committee. While most people testifying at that hearing expressed their support for total repeal of this burdensome section of the tax code, it is my understanding that in lieu of repeal, alternatives to section 2036(c) will be included in this year's budget reconciliation bill. To date their proposals for change are basically unsatisfactory.

Wyoming has America's largest number of small businesses per capita. These are family owned and operated. If these small businesses are taxed in the manner proposed by section 2036(c), many families will be forced to sell all or portions of their business in order to pay estate taxes. I don't believe this burden was ever intended by Congress and if it was it is completely inconsistent with our belief in a free society. With that in mind, I sincerely hope that we make the necessary reforms in our tax code to prevent further erosion of a small business owner's ability to pass their business from one generation to the next.

With regard to the self-employment health insurance tax deduction, I do have a few comments to make about its impact on small businesses. Prior to 1987, small, self-employed business owners were not allowed a deduction for health insurance premiums, compared to a 100 percent deduction for owners of incorporated businesses. This provision expires in December and the Treasury Department has proposed eliminating this provision. Because I believe the loss of this deduction would be a major disincentive for small businesses to offer health insurance to their employees, I have cosponsored the legislation introduced by Senator Durenberger to extend this tax deduction another five years. While some would argue that this is a costly proposal, compared to the cost of mandated health insurance for all employees, its impact is minimal. It would seem to me that Section 89 alone has caused enough problems with employee benefits, and we certainly don't need to exacerbate that problem by eliminating this deduction for the self-employed.

As far as FICA reporting and payroll taxes are concerned, while I have not heard from any businesses in Wyoming about the problems posed by these two complicated taxes, I look forward to hearing the views of those testifying here today. Perhaps we can reach some sort of consensus on what changes are needed to make these two laws to make them simpler and less costly to comply with.

Senator BOREN. And thank you very much, Senator Wallop. Indeed, we have worked together for a long time, 10 years or more now, on these issues, including our earlier efforts to try to keep the small family business in a survivable situation and before that the bill, which I believe was about the first bill I ever authored after coming to the Senate, successfully passed, to do away with the Federal inheritance taxes on spouses which also is the question and burden of showing contribution was being placed, particularly on small business and farm spouses when, obviously, they were partners in everything that was done and should not have had a tax consequence when the spouses were inheriting from each other. So, we have worked together for a long time to try to move us in this direction.

Senator Boschwitz.

Senator BOSCHWITZ. If I could comment. The first thing that I sponsored when I came here was the provision by Senator Byrd who was objecting to the idea of capital gains at death. And that is probably coming up again. So, we always have our work cut out. Just when you think you have made progress, you have to start up again.

Senator BOREN. We are faced by those who come in and then take the sensible things out of the code as was done in the case of many sensible things in the so-called Tax Reform Act.

Senator Baucus from Montana has also joined us. And Senator Baucus again has been a partner in these efforts on estate taxation in the past to fight for sensible policy. He is very sensitive to the needs of small business people, of small farmers and others. And, Senator Baucus, we are very glad you have joined us this morning. Do you have any opening comments you would like to make?

STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM THE STATE OF MONTANA

Senator BAUCUS. No opening statement, Mr. Chairman, except that this is a very important hearing. We all hear frequently from our people at home about estate freeze provisions and others that are on the agenda this morning.

I am reminded of Section 89. That is a provision of the law that was some say—and I think basically it's true—enacted with good intentions but which has turned out to be an immense burden upon people and inordinately complex. Many feel Section 89 should be repealed just as Section 2036(c) should be repealed. That very well may be true. And like Section 89, if it can't be fixed, I think it probably should be repealed.

And I hope that at these hearings, we will find a way to answer that question because this section and others fall into that category. The more we in the Congress can prevent sections like Section 2036(c) and Section 89 and others from becoming the mess that they are, the better service we will have provided to our people and our country.

But I thank you for the hearing. It will help answer some of these questions.

Senator BOREN. Thank you, Senator Baucus. As you say, we have so much rhetoric about maintaining small businesses, opportunities

for small businesses, keeping family operations intact, maintaining local ownership so that every asset in this country is not controlled by a few large national or international conglomerates, and then we seem to be doing everything possible through the back door in tax policy to cause just exactly that result to happen.

Montana is out in force today. I see Senator Burns has also joined us this morning. Senator Burns, we are glad to have you here along with your colleagues. Are there any opening comments that you would like to make about this matter?

STATEMENT OF HON. CONRAD BURNS, A U.S. SENATOR FROM THE STATE OF MONTANA

Senator BURNS. Not much. Thank you, Mr. Chairman.

Senator Baucus and I have just come off a cattle drive. He made it all, and I made half of it.

Senator BOREN. He is running for reelection next year. [Laughter.]

Senator BAUCUS. I'm twice as sore, also closer to election. [Laughter.]

Senator BURNS. I think Senator Baucus and you too, Mr. Chairman, have sort of summarized our thoughts on this. Basically in Montana and as Senator Baucus and I both heard over the August break in Montana, we are a small business State, in other words, those businesses that hire less than 15 people. And we are that kind of a State and a resource-based State. And we try to get into a situation where we try to encourage those businesses on added value.

And this type of legislation—and, of course, I am just brand new here, but it is beyond me how the Congress in its wisdom can let this type of legislation slip by. In other words, we know the dealings of Congress and how these things finally appear.

But it is fairly evident that in our States that are resource based that the taxation and the tax situation do more to limit our ability to keep those small businesses going and to pass those businesses on to the next generation. They are family businesses. They are the business the father started or the grandfather did. It has been passed on to the father, and now it has to go on to another generation. And it is very important to the business fabric or the business community in our States.

And we know that the limited availability of venture capital to start new businesses is very limited this time in this country. In other words, there are not very many businesses that are really making the 12, 15 or 20 percent return on investment to get it started. So, the established business is a backbone of this country so far and especially in the small business world.

So, Mr. Chairman, I applaud you for holding these hearings. I think whatever we hear today that we want to—and I think it is a bipartisan issue that we all work together and make sure that we have a healthy and viable business environment because from that comes jobs and from that comes families that are the backbone of this Nation, the guy that carries the dinner bucket. He wants to pay for a home, and he wants to educate children. And he wants the opportunity to progress too.

And so, this has many ramifications. It's a ripple effect. It goes through the complete fabric of our economic community.

So, I applaud you and our Ranking Chairman, Senator Boschwitz, from Minnesota. By the way, he is up for election too. I didn't see you on the cattle drive, Senator. [Laughter.]

I was sort of disappointed in that.

But I applaud you and thank you and look forward to these hearings.

[The prepared statement of Senator Burns follows:]

STATEMENT OF SENATOR CONRAD BURNS
OF MONTANA
SENATE SMALL BUSINESS COMMITTEE
SEPTEMBER 13, 1989

Mr. Chairman, I want to thank you and the ranking member for conducting these hearings today. The distinguished Senator from Minnesota, Mr. Boschwitz, and the able Senator from Oklahoma, Mr. Boren, are very well aware of the impacts the subjects we will discuss today have upon small businesses in their states. Coming from a state where small business plays an important role, I am very well of those concerns as well.

One of the reasons I wanted to serve in the United States Senate was to see to it that unnecessary government regulation and red tape does not stifle economic progress among this nation's small business community. Too often we forget that rules and regulations place an unnecessary strain and burden upon small businesses.

Mr. Chairman, today we are talking about the worst form of government regulation, excessive taxation. In the case we have before us here today, we are effectively elimination small, family run businesses. By requiring the heirs of an estate to come up with hugh sums of money, to pay outrageously high taxes due to the elimination of "estate freezes," we are placing an overwhelming burden on American families. Small businesses rely on the family to provide the hard work, ingenuity and enthusiasm to build

a successful company. We are effectively removing any incentive for family members to continue to carry on the dedication and hard work which has built the business in the first place. I don't believe children will dedicate their entire lives only to see the fruits of their labors eliminated by excessive taxes.

Mr. Chairman, this country was founded on the principle that good hard work, dedication and a commitment to excel, would prove beneficial in the long run. However, with the addition of Section 2036(c) to the Internal Revenue Code, we have effectively eliminated any incentive to be successful as a small business entrepreneur.

My state of Montana with all its farms, ranches, and family owned business will suffer adversely because of this provision. I have cosponsored legislation that seeks to repeal this section. Even though, I anxiously await the testimony of today's panel and am looking forward to hearing any alternative suggestions that they might have.

Senator BOREN. Thank you very much, Senator Burns.

I appreciate the comments from all the Members. From listening to the comments that were made, we ought to just take a vote this morning. [Laughter.]

It sounds like about the right mix of views this morning to me on the Committee this morning.

We have as our first panel Mr. Frank Swain, the Chief Counsel of the Office of Advocacy of the Small Business Administration, and also Mr. John Motley, director of Federal governmental relations with the National Federation of Independent Business. We are very glad to have both of you.

And, Mr. Swain, we will begin with your statement at this time. Let me say to both of you since we have a number of panelists this morning, please feel free to summarize the main points of your statements—we will put the full statements into the record—and to put the emphasis on the major points that you would like to make. Mr. Swain, we are glad to have you this morning.

STATEMENT OF HON. FRANK SWAIN, CHIEF COUNSEL, OFFICE OF ADVOCACY, U.S. SMALL BUSINESS ADMINISTRATION, WASHINGTON, DC

Mr. SWAIN. Thank you very much, Senator Boren and the other members of the panel.

I think it is exceedingly important that this Committee has decided to hold a hearing on these critical issues. As several of your opening statements alluded to, many issues of national interest occur in front of the Finance Committee and every once in a while, in taking care of those issues of national interest, something of less than national interest but of essential importance to the small business community works its way into the statute. Certainly Section 2036(c) is a prime example.

I guess I should start out by saying in the interest of full disclosure that, of course, although I represent the Small Business Administration, the Treasury Department may have some different views on some of the provisions that we are discussing here this morning. So, I have been cautioned that I do not officially speak for the Administration, but one would hope that I might be influential from time to time even though I do not officially speak for them.

On these particular issues that are so important to small business, let me summarize the three issues that I think are of key importance.

First of all, Section 2036(c). That tax law only affects businesses once normally. It affects businesses at the time of the death of the principal owner. And the effect is so significant that, if the estate plan is not set up in strict keeping with what is allowed under Section 2036(c), there may be as much as a 60 percent tax on assets.

I might add as a sidebar that that 60 percent represents somewhat of a backward trend from the good progress made by your legislation back in 1981. We understand there may have been revenue reasons, but, nonetheless, in 1987 and 1988 the Congress raised the estate tax again, or at least failed to lower it as it was scheduled, and on top of that threw in this Section 2036(c).

Senator BOSCHWITZ. You said 60 percent. Isn't the top 55?

Mr. SWAIN. The top is 55 percent, Senator Boschwitz, but my understanding is that by instituting a recapture provision the unified gift-estate tax credit, that the actual rate of taxation for certain taxpayers in certain income levels is higher. And then after you acertain very high income level, the tax drops back down to 55 percent. I would be happy to double check that and submit some information on the record.

Senator BOSCHWITZ. It really is confiscatory.

[Material follows:]

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF CHIEF COUNSEL FOR ADVOCACY

October 30, 1989

Honorable Rudy Boschwitz
United States Senate
Committee on Small Business
Washington, DC 20510

Dear Senator Boschwitz:

During the September 13, 1989 hearing before the Small Business Committee on the estate tax freeze provisions, you inquired about the top rate of taxation imposed on the devolution of business property in an estate. My statement was that the top Federal estate tax rate on business property as a result of the anti-estate freeze provision in Internal Revenue Code Section 2036(c) might be as high as 60 percent. I also indicated that this is because, in 1987, the Congress effectively raised the estate tax.

The top marginal rate of federal taxation on the transfer of business properties may be as high as 60 percent because of two factors: (1) the rate recapture provisions added in the 1987 Omnibus Budget Reconciliation Act (OBRA); and (2) the deferral in OBRA of the scheduled decline in gift and estate tax rates.

Under the rate recapture provisions of OBRA, the benefit of the unified credit and graduated rates is phased out for transfers of over $10 million which are made after December 31, 1987. This phase-out employs a mechanism similar to that utilized in phasing out the 15 percent income tax rate bracket for upper income taxpayers: by applying a 5 percent surtax on amounts over $10 million dollars until the benefit of the unified credit and the graduated rates is recaptured. As a result, the marginal rate of gift and estate tax on transfers of between $10 million and about $21 million is 60 percent.

Furthermore, before OBRA, the estate and gift tax rate was scheduled to decrease to 50 percent for taxable transfers over $2.5 million. However, OBRA deferred the reduction until December 31, 1992, so that the 1987 rate of 55 percent will continue to apply on transfers over $3 million.

The combined effect of the rate recapture provision and postponement of the reduction in rates imposes a rate on business taxpayers which you have correctly termed "confiscatory." The important point, of course, is that I.R.C Section 2036(c) applies this high rate of tax irrespective of the nature or liquidity of the asset. It is irrelevant whether the assets are cash, marketable securities, collectibles or an ongoing business. And although application of this high rate of tax to an ongoing business is intended to tax the wealth of the entrepreneur, the resulting liquidation or sale of ongoing family businesses is a consequence of significant concern to the Small Business Administration.

As I testified at the hearing, we strongly recommend that the existing I.R.C Section 2036(c) be scrapped. If estate and gift tax administration requires better procedures for reporting and evaluation, the Congress should focus on those problems and eliminate the confusing changes embodied in Section 2036(c).

Yours very truly,

Frank S. Swain
Chief Counsel for Advocacy

cc: Senator Dale Bumpers
Senator David Boren
Administrator Susan Engeleiter

Mr. SWAIN. Let me try to describe what Section 2036(c) does, and I cannot describe it simply, but I will at least lay out a theme.

Section 2036(c) applies if a businessowner, in effect, transfers an interest with a disproportionately large share of the potential appreciation in the business while retaining an interest in the income or rights of the enterprises. In other words, as much as I can gather in talking to businessowners and talking to estate lawyers, you are in danger of Section 2036(c) anytime you transfer as principal owner part of the business, but keep some sort of interest in it.

And it is important to realize that whoever these people are that think that it was written to cure terrible estate planning abuses, the fact of the matter is that the language of Section 2036(c), in some cases made worse by the 1988 changes, really operates to rope in a number of absolutely routine business estate planning devices. Basically any time the principal owner retains an interest, whether it is a payment on a loan or whether it is a consulting contract, if the interest is at all contingent on the appreciation of the business or the growth of the business, the owner is in jeopardy under Section 2036(c).

Section 2036(c) only applies to transfers in families. If I have a business and I transfer it to Mr. Motley, we do not worry about Section 2036(c), but if I have a business and I transfer it to my son or daughter, then I have to worry about whether I keep an interest in it. And if I keep some sort of interest in it that is triggered by Section 2036(c), then when I die, the business appreciation between the time that I transferred that property and my death is taxed in my estate. This is an absolutely terrible provision for most active family businesses that are considering some sort of transfer, yet where the original owner wants to maintain some sort of interest.

You will hear from a lot of other witnesses today that I'm sure will present examples in much more vivid tones.

Basically the law, as it stands now, is unworkable and should be repealed. Whether there are certain problems with estate tax valuation and gift tax valuation in which new laws are appropriate, that is another subject. It seems to me that if there is a transfer made and the transfer is not made at a proper valuation, then that is a reporting problem; that is a recordkeeping problem. And perhaps the transferors ought to be required to submit better documentation than they currently do to the IRS. But Section 2036(c) is really a draconian solution to a problem which I do not think anywhere on the record anybody has given any evidence of its extensiveness.

I also might add that, based on our background and research on the issue, this is not a proposal that originated in the Reagan Administration. It is not a proposal that originated in the Senate. It is a proposal that originated in the House, and I hope that the Senate can take the lead in making some changes.

Basically the law is overbroad; it is over-reaching. I think that it ought to be repealed. I think that if it is replaced, it ought to be replaced by something tremendously simplified that focuses on recordkeeping and valuation provisions and does not focus on actual taxing provisions. And I will defer to the much more expert witnesses who actually run family businesses who will testify after me to tell you their personal examples on why these are problems.

Let me make a few brief remarks on the two other issues on the agenda this morning. First, the 25 percent deductibility on individual tax for health insurance.

Right now if Frank Swain, Inc. pays a salary to Frank Swain, Frank Swain, Inc., can also buy health insurance for Frank Swain and have that 100 percent deductible as a business deduction against Frank Swain, Incorporated's income taxes.

If Frank Swain, sole proprietor, attorney at law, buys health insurance for Frank Swain, this year I can only deduct 25 percent of the cost of that insurance for myself. And next year I cannot deduct any because the 25 percent deduction that is available this year runs out at the end of this year.

I think that that is absolutely senseless tax policy that makes a distinction between whether a person is doing business in corporate form or doing business in individual form as to whether he or she may deduct a health insurance premium.

Second and perhaps of equal importance, it is absolutely senseless health care policy. There are approximately 30 million people in this country that do not have health insurance—analyses show that fully 25 percent of those are people that are either self-employed or employees of self-employed. And yet, the proposal is to take away this very limited deduction, to take away the limited incentive the self-employed do have under the current tax laws to purchase health care insurance.

I would strongly encourage the Congress to not only continue the 25 percent deduction for individual purchases of health insurance, but also to increase no deduction if at all possible under the revenue provisions.

Finally, I might briefly mention the FICA reporting problems. The House seems to be making some good proposals on lowering the penalties in FICA reporting. Let me simply say that there are a lot of penalties that the IRS issues for mistakes in reporting, many of which they quickly abate because they are quickly cured or they are record-keeping mistakes.

We have suggested to the House that rather than slapping an immediate high penalty on late reporters, that there be a tiered penalty, that it be 2 percent, 5 percent, 10 percent, depending on how late the tax is. The House has accepted some of those suggestions, but gone the other way and increased some other penalties.

We think this is a tremendously vexing problem for small businesses. There are 5½ million payroll tax taxpayers. The payroll tax payment requirements are very complicated. And we think that the penalty rationalization is something that is very important to small business and to family-owned business.

Thank you very much, Mr. Chairman and Members of the Committee.

[The prepared statement of Mr. Swain follows:]

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF CHIEF COUNSEL FOR ADVOCACY

TESTIMONY OF

HONORABLE FRANK S. SWAIN

CHIEF COUNSEL FOR ADVOCACY

U.S. SMALL BUSINESS ADMINISTRATION

BEFORE THE COMMITTEE

ON SMALL BUSINESS

OF THE UNITED STATES SENATE

ON THE IMPACT OF CURRENT

TAX LAWS ON SMALL BUSINESS

SEPTEMBER 13, 1989

Mr. Chairman and Members of the Committee on Small Business:

Thank you for the opportunity to share my views on several important small business tax policy issues; the anti-estate freeze provision contained in Internal Revenue Code (I.R.C. or Code) 2036(c), employment tax requirements and the health insurance deduction for the self-employed. These are among the issues of greatest concern to the small business this legislative year, and you are to be commended for bringing them to the forefront of the tax policy debate. Other issues of importance include I.R.C. Section 89, the R&E tax credit, the capital gains differential, implication of the uniform capitalization rules and erosion of independent contractors status.

As you know, the Treasury Department is the primary spokesmen for the Administration on tax issues. These views are those of the Chief Counsel for Advocacy and do not necessarily reflect those of the Administration.

I believe that the principal matter to be discussed today is the impact of the anti-estate freeze provision on family owned businesses. Unlike payroll taxes or the health insurance deduction, 2036(c) may theoretically affect a business owner only once in a lifetime, but its effect is of such magnitude that it slices at the very essence of the family business and interferes with the ability of business owners to do what they have toiled many years to achieve: transfer the business to their children.

In addition to achieving its primary objective of preventing abusive estate planning devices, it prohibits common transactions for transferring business assets, favors families whose wealth is represented by marketable securities over those who own small businesses and farms, discourages childrens' involvement in family businesses, and dramatically increases the tax costs of transferring ownership in family businesses, encouraging the break-up or sale of those businesses. Like Section 89, Section 2036(c) has emerged from a little known technical provision to appropriately capture the full attention of the business community. Section 2036(c) must be repealed pending thorough Congressional review of the important underlying tax policy issues.

Close behind in importance, are the problems associated with the employment tax system, particularly the Federal tax deposit system. While the frequency of the required deposits and the burdens they impose on small businesses are important considerations, I would like to confine my remarks to what I believe is at the core of the problem: the administration of payroll tax penalties for the failure to deposit in a timely fashion. More than 10 million penalties for payroll tax deposits have been assessed each year against the approximately 5.7 million employers, and according to a recent survey conducted for the SBA, a majority of business taxpayers receiving penalties believe the penalties are assessed in error. The restructuring

of this penalty is currently being debated by the Ways and Means Committee, and we support substantial legislative and administrative reform in the area.

Third is the need not only to maintain the 25 percent health deduction, but to expand that deduction to 100 percent. In conjunction with significantly higher health costs, small employers may have to contend with complex and costly regulations, such as Section 89. Despite this, the self-employed have never been able to fully deduct health care premiums. At a time when we need to be encouraging the provision of health care, expiration of this deduction is poor tax policy.

Anti-Freeze Rule of I.R.C. 2036(c)

Background

Section 2036 (c) was enacted as part of the Omnibus Budget Reconciliation Act of 1987 and was broadened by the Miscellaneous Revenue Act of 1988.[1] Its purpose was to prevent abusive circumvention of the estate and gift taxes through the use of estate freezes.

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[1] Effective for estates of decedents dying after December 31, 1987, the 1988 Act further expands upon I.R.C. Section 2036(c) by eliminating the requirement that the retained income or right must constitute a "disproportionately" large share of income or rights. The Act also provides that the original transferror will be treated as having made a gift if all or a part of the retained interest is transferred before death or if the original transferee transfers the interest to a person outside the original transferror's family.

Technically, Section 2036 (c) applies if a business owner "in effect" transfers an interest having a disproportionately large share of the potential appreciation in the business while retaining an interest in the income or rights of the enterprise.[2] Section 2036 (c) then serves to pull the value of the appreciated interest back into the estate for purposes of taxation many years after the rights to future appreciation were transferred. If the transferor continues to hold the retained interest until death, the value of the transferred property will be included in the transferor's estate. If the transferor's retained interest terminates or if the transferred property is disposed of outside the transferor's family, the value of the transferred property will be treated as a deemed gift. In either case, the original transfer will be taken into account so that the general effect of I.R.C. Section 2036 (c) will be to tax the post-transfer appreciation in the value of the transferred property from the time of such inclusion or deemed gift. The provision has been estimated by Treasury to generate $2 million next year and $72 million in 1991.[3]

Many common estate planning devices are now subject to 2036 (c),

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[2] Not only controlling owners are subject to the provision. The "substantial interest" needed to invoke the application of I.R.C. 2036 (c) ownership of 10 percent or more of the voting power, income stream or both.

[3] For Fiscal Year 1989 - $2 million, 1990 - $25 million, 1991 - $72 million, 1992 - $146 million, and 1993 - $249 million.

such as stock recapitalizations. In a typical stock recapitalization, a portion of the parent's common stock was converted into preferred and the remaining common stock was given or sold to the children. The common stock was assigned all future appreciation in the business, and the preferred was assigned fixed liquidation and dividend rights. If the transaction were properly executed, upon the parent's death, the preferred stock would be redeemed for liquidation value, the children would obtain control and appreciation would be received without tax consequence. Under 2036 (c), however, the value of the appreciation after the transfer will be brought back into the decedent's estate, regardless of the efforts of the children in generating that appreciation.

The tax benefits of stock recapitalizations and other "estate freezes" were significant, since the appreciation of the business after the recapitalization might have been taxed at a rate as high as 60 percent when one includes state tax impacts. "Freezes" also were popular because preferred stock provided retirement security, the parents retained legal control through voting rights, children were given an incentive of appreciation attributable to their efforts and estate taxes were determined in advance.

There was nothing illegal about these transactions. The Unified Transfer Tax Act, and the case law which followed had long

permitted shifts in future appreciation. However, there was some concern that many such transactions were often abusive in other than arms-length contoxts because the value of the gifted or retained interest, if set too low, could evade notice until a significant time after the transaction took place. The potential for "abuse" also existed because of the subsequent action or inaction by the transferor with respect to the retained interest. Enacted in 1987 and expanded in 1988, 2036(c) was the new weapon the IRS sought to close the estate freeze "loophole." By broadly drafting I.R.C. 2036(c), Congress sought to cover various types of "abusive" estate freezes.

Problems with Section 2036 (c)

Proponents of 2036(c) argue that the law is necessary to curb aggressive tax avoidance schemes by estate planners. This Committee must recognize, however, that the grass roots efforts to repeal 2036(c) by the business community are not grounded in the desire to merely resurrect an avoidance device. The issues before this Committee are more fundamental than that, and go to the heart of tax policy debate over the imposition of estate taxes on business assets.

Two fundamental questions underpin today's hearing:

* Can the provision be more appropriately drafted to

accomplish its goal of applying the estate tax laws to transfers of family business interests?

* What are the appropriate policy rationales for the tax treatment of bequests of active business assets?

The immediate problems with the provision are three-fold. First, the provision is unclear in its application. The provision might apply, for example, when a business interest is exchanged for a promise to pay a fixed purchase price. Almost any family transaction in which one member gives or sells to another an equity interest in the business, retaining the right to receive a fixed dollar amount or disproportionate voting rights may be affected. The new IRS Notice 89-99, does provide some guidance with respect to selected issues arising under 2036(c) of the Code, but is not dispositive of these issues.

Second, where it is clear, it is overreaching. Although practitioners differ over exactly which transactions will be under its purview, all agree that it will encompass many legitimate, non-abusive family transactions never intended to fall within its scope. The provision attaches to almost all transfers of future interests in closely held businesses, effectively endangering, if not prohibiting, common sense methods for transferring business ownership. In its efforts to quash an

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"abusive" avoidance device, involving the undervaluation of transferred interests or the manipulation of dividend rights, it elevates tax administration over sound business planning.

Third, the provision is grossly inequitable because it offers an estate tax solution to a gift tax problem. It disregards the considerable efforts that the recipients of the future appreciation in the businesses have made in achieving that appreciation. Irrespective of their efforts, 2036(c) pulls the gift which bears their hardwork, determination and judgment back into the estate of the previous owner. It operates to tax the fruits of the children's labor in someone else's estate, that of the previous owner. This estate tax solution can yield highly punitive results. A $50,000 gift can result in the inclusion of $1,000,000, or in the alternative a $1,000,000 gift can result in the inclusion of $50,000. The provision can also apply to tax an estate which at the time of the transfer was below the $600,000 exemption level.

How this might operate in application to a family business is easy to imagine. Assume, for example, that an owner of a manufacturing company has struggled for many years to develop that business into a moderately successful enterprise of 15 employees, many of some of whom have spent the better part of their lives with the company. During development of the business there were the usual ups and downs, the competition was fierce,

but the business eventually assumed an established position in the marketplace. Indeed, part of the profits of the business went to pay for the education of the owner's two daughters, one of whom received an MBA.

After many years, the owner reached an age where he wished to pass on the business to the daughters who had learned the business from the ground up. Although he trusted in his daughters' abilities, rather than give his entire interest to them outright he chose to relinquish control by keeping an interest in preferred stock and giving to them future appreciation in the value of the business. Voting control would be relinquished over a period of time.

The father lived to a ripe old age and retired in a warm southern climate. In the ensuing years, the daughters, with their combined business acumen and drive, were able to turn the business into a larger successful company, with several manufacturing plants. The business, which at the time of the gift grossed $1 million annually , grossed $14 million annually at the time of the father's death. Its assets had increased from $500,000 to $7.5 million and it had reached a total value of $26 million, appreciating from the time of the gift by $23 million. Despite the efforts of the daughters in increasing the value of

the company 9 times, the entire appreciation will be attributable to the father, brought back into his estate and subject to tax at a rate exceeding 50 percent.

In order to pay the taxes, the daughters were presented with an ultimatum: spin off some operations and reduce the workforce at the home plant or sell the business to pay the taxes. Rather than split the business and start anew, the daughters elected to sell the business to the highest bidder, which happened to be a foreign investor. While the transactions, fact patterns and industries will differ, a version of this scenario will be reenacted over the next decade as Section 2036 (c) applies to more and more estates.

Assuming that Congressional intent is to fully tax the devolution of businesses assets, undoubtedly better alternatives can be fashioned. One method would be to require the firm to provide a detailed appraisal at the time the transaction is consummated which sets forth the value of the company and the retained interest. We appreciate the difficulty the IRS has in valuing these interests twenty years after the transaction. This would give the IRS an opportunity to immediately assess the gift tax applicable to the transfer.

I believe, however, that even if we are able to fashion an appropriate method of valuing transfers and ensuring full

compliance, the problem will remain only partially solved. The imposition of estate taxes on business property, which can apply at rate of between 37 and 55 percent, is inherently different from the imposition of such taxes on personal assets. Unlike taxing the devolution of wealth in the form of collectibles, publicly traded securities or cash, the taxing of businesses can affect business continuity by hindering the ability to transfer a business intact from one generation to another.[4]

The issue is distinct from the more philosophical debates concerning the accumulation of family wealth and personalty. It can affect the ongoing concern of the business, it can affect the employees of the business; it can reduce the good will of a business that has long been generated; and, it can dismantle a successful economic unit that has succeeded in innovating, generating new jobs and last but not least -- paying taxes. Yet, more leeway is currently provided for the transfer of personal assets. Tax laws should help preserve family businesses, not encourage their sale and break-up. The issues surrounding 2036(c) should be approached in this light.

Moreover, Congress should recognize that the principal justification for estate taxes is not to bring in significant

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[4] A similar concern led to the modification of the "proportionate disallowance rule" in 1987, which had required businesses to report gain from installment obligations in the ratio that their outstanding debt bore to assets.

revenue, but to place limits on the concentration of wealth upon the taxable event which separates that wealth from its owner. The justification is questionable, at best, when applied to indivisible family business assets. The amount foregone through estate freezes is a small portion of the amount taken in from estate and gift taxes and an extremely small portion of the total tax dollars generated from all sources.

According to the 1988 Commissioner's Annual Report, the total revenue generated from estate and gift taxes constitutes less than 1 percent of the total revenues collected in the U.S. For fiscal year 1988,[5] some $7.3 billion were collected from estate taxes and $455 million from gift taxes, as compared with $935 billion from all sources. While the statistics are not broken down extensively, noncorporate assets comprised a small amount of total estate assets, $2.7 billion as opposed to $66.9 billion. The relatively small amount of revenue gained does not justify application of the high rates of estate taxes on family businesses.

Estate freezes have traditionally provided a reasonable means of relieving transfer tax problems for the family business. The movement to repeal section 2036(c), however, may not be the optimal solution. While repeal will reinstate complex devices that have long enabled small business owners, particularly ones

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[5] Fiscal year ending September 30, 1988.

with tax counsel, to keep the business in the family, it is not the best solution. I believe that the problem surrounding 2036(c) should be solved, not by statutorily approving devices that have been developed to minimize estate taxes through the back door, but by expressly recognizing that the transfer of business assets must be treated differently under the tax laws.

Retention of the 25 Percent Health Insurance Deduction for the Self-Employed

It is widely known that the current tax incentive system for health care unfairly disadvantages the self-employed, owner-operators of unincorporated small businesses. Until changes made in the Tax Reform Act of 1986 (TRA), the 13.5 million self-employed had to purchase their health insurance out of after-tax profits; they received no tax subsidy at all. This situation was particularly ironic for the owner-operator of a business who provided health insurance for his or her workers. A self-employed person may provide a health insurance plan for his business and pay 100 percent of the premium for the employees; the value of the health insurance would be excluded from the workers' income, but the owner of the business would not receive a dollar of tax advantage from participation in the plan.

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The TRA modification, allowing the self-employed to deduct 25 percent of their premium cost from their taxable income, is far less than the tax benefit the firm receives for employees or the beneficiary to their corporations whose premiums for managers are 100 percent deductible. The 25 percent deduction for the self-employed should be increased to 100 percent as a matter of fairness.

And there is more than just tax equity to recommend the expansion of this deduction. Unfortunately, the debate over the best method to accomplish wider provision of employer sponsored health care among employees and firms has moved in the wrong direction for many years. Most of the working uninsured are found in smaller firms not because firms are less willing to provide their employees benefits, but because smaller firms cannot afford to provide health care coverage. Indeed, research conducted for the Office of Advocacy, U.S. Small Business Administration, shows that of the small firms that maintain health plans for their employees, health benefits are more equitably distributed. The major hurdle in the provision of employer-sponsored health care coverage is cost. Small firms incur higher premiums and fixed costs, experience more frequent employee turnover, and more often utilize part-time and seasonal employees. The typical small business owner will have to pay 10 to 40 percent more for health insurance per employee than will a larger firm. Moreover, our studies indicate that the form of ownership is related to the

probability of offering health insurance; corporations are more likely to sponsor plans than firms with other forms of ownership.

From a health care access perspective, elimination of the self-employed medical insurance deduction makes no sense. The self-employed generally do not buy health insurance. In fact, the uninsured self-employed constitute one in four of the total uninsured population, according to an analysis of the Federal data by the Employee Benefits Research Institute.

There can be significant stimulation of insurance purchasing by the self-employed through continuing the deduction. Elimination of the 25 percent deduction for sole proprietors, in conjunction with burdensome regulations such as Section 89, adds cost to the employer-sponsored health care system; discouraging, rather than encouraging, the extension of health care.

Extension of the 25 percent deduction has been estimated to cost $147 million in 1990, rising to $423 million in 1994.[6] This is a small sum in comparison to the $24.2 billion provided for the exclusion of employer contributions for medical insurance premiums and medical care, another incentive plan.[7] Furthermore,

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[6]Fiscal Year 1990 - $147 million, FY 1991 - $268 million, FY 1992 - $319 million, FY 1993 - $368 million and FY 1994 - $423 million.

[7] Special Analysis G of the Federal Budget, 1988.

the deductibility of medical expenses for all business entities is estimated to cost $1.8 billion. Maintenance of the 25 percent deduction and ultimate expansion of that deduction to 100 percent are priority items for small business.

FICA Taxes and Payroll Reporting

As I mentioned, the most needed reform in the payroll tax system is in the sanctions that apply for failure to timely deposit. Widespread Congressional attention has been focused on reform of the payroll penalty structure as part of a broader review of penalties in general. Comprehensive studies of the tax penalty system have recently been concluded by both Houses of Congress, most major practitioner groups and the IRS Executive Task Force.

This review has been for good reason. Over the last 15 years, tax penalties have evolved from the conventional wisdom that stricter sanctions and stronger enforcement lead inevitably to greater compliance and respect for our voluntary tax system. Each time a remedy for a new abuse was sought, another penalty was added to the Code, without sufficient consideration as to how these new penalties interrelated with penalties designed to punish similar conduct or neglect. As the penalties steadily increased in numbers and severity, small employers and practitioners, struggling to comply with constantly changing and

exceedingly complex tax laws, experienced increasing frustration. Until recently, no comprehensive review of the effect of these penalties on the taxpaying community, including the business community, was undertaken.

The consensus of these studies is that we have arrived at the limits of this conventional wisdom. The more than 150 separate sanctions currently contained in the Code, comprising more than 40 separate Code sections, have resulted in an overlapping penalty structure which is difficult for the IRS to enforce and for the small business taxpayer to comprehend. The extant penalties have been perceived by small business taxpayers as too numerous, too harsh, and too complex. The enforcement of these penalties, rather than instilling respect, has contributed instead to a serious erosion of faith in the equity of our voluntary tax system.

The principal area of concern from the small business standpoint is in the administration of payroll-related tax penalties. Payroll-related penalties have the single, greatest impact on small business and are the most frequently asserted. Employment taxes are paid by more than 5.7 million businesses and collectively constitute more than three-quarters of all revenue received through taxes. Each year, however, the IRS assesses an extremely large number of payroll tax-related penalties. For the past six years, an average of 10 million such penalties has been

assessed annually, and about 20 percent of the penalties have been abated or set aside for one reason or another. Last year those penalties resulted in a total net liability of more than $2.5 billion.[8]

Furthermore, a study conducted for the SBA shows that taxpayer perception of the fairness of the penalties was intolerably low. Data from the survey, show that 26 percent of the taxpayers surveyed claimed they had received assessments for employment-related returns, and 64 percent reported that these penalties were erroneously assessed. Of the taxpayers claiming penalty assessments, 89 percent reportedly protested and 66 percent of those protests were reportedly successful.[9]

Whether the penalty is dismissed because of IRS error, or is forgiven by the IRS for reasonable cause, the procedures from protest to abatement are costly, time-consuming, and add greatly to the frustration of small employers. The problem is exacerbated by unyielding requirements for timely deposit, which provide no margin of error on the part of banks, taxpayers, check processing institutions or IRS data entry personnel.

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[8]IRS Commissioner's Annual Reports.

[9]Brown and Associates, "A Survey of Erroneously Assessed Payroll Tax Penalties."

Statistics such as these reveal significant deficiencies in our current payroll system, illustrating the need for change, at least, in the administration of these penalties. Reform of the payroll tax system was also voted among the final recommendations of the White House Conference on Small Business conducted in 1986.

The Office of Advocacy has been very active in the debate on civil tax penalties reform. We met with the IRS in 1988 and testified before the Ways and Means Committee, Subcommittee on Oversight in July 1988 and June 1989 on this subject. We have also worked with committee staff, small business groups and task forces to fashion language which would improve upon the civil tax penalty structure, particularly as it relates to payroll taxes.

The initial reform proposals by the House Ways and Means Committee included changes which would phase in the full application of the penalty as a function of the time in which deposit is delayed. The proposal would permit taxpayers, who have missed deposit dates, to be penalized at a lower rate of 2 percent for up to 5 days late, 5 percent for up to 15 days late and the full 10 percent thereafter. The Committee on Ways and Means resolved during mark-up, however, to maintain that phase-in but to increase the penalty 50 percent, from the current 10 percent to 15 percent, after notice and demand is given. Since the penalty is not assessed upon audit, but upon the filing of

the Form 941, this penalty will apply after the discrepancy is detected by the Service, immediately upon the issuance of the first notice. Imposition of this penalty is meant to maintain revenue neutrality by raising approximately $750 million over 3 years.

Clearly, the Ways and Means original proposal to create a three-tiered system that would relate severity to delinquency has the potential for reducing many of the problems caused by inadvertent or clerical mistakes. We believe a three-tiered structure of 2, 5 and 10 percent would provide adequate incentive for timely deposit by doubling and redoubling the penalty over a period of 15 days. However, we do not agree with the Ways and Means Committee that escalation of this penalty to 15 percent would be useful in increasing compliance. We would also note that grossly delinquent taxpayers may be subject to mounting interest rates, and other penalties, including the 100 percent penalty for intentionally retaining trust funds.

In conjunction with phasing in the penalty over a period of time, certain procedural changes are needed to minimize administrative costs to the taxpayer and to the Service of resolving disputes over abatable or erroneous penalty assessments. In particular, I ask that Congress require the Service to:

* Specify in the Notice of Penalty the name of an individual in the taxpayer's IRS District who has jurisdiction over penalty enforcement and who is empowered to resolve the dispute on first contact or by prompt reply (or use some other system to ensure, to the extent possible, consistency in IRS-taxpayer contacts); and,

* Place a hold on further action, such as sending the taxpayer more Notices, once a protest is received.

Procedural reforms are necessary so that administrative costs to the taxpayer and the Service of resolving disputes over abatable or erroneous penalty assessments are minimized.

Conclusion

I urge the Committee to recommend that Congress take a hard look at the tax policy underlying 2036 (c). While some abuses may have given rise to the provision, the provision has devastating effects on the ability of small business owners to transfer ownership of their businesses to the party of their choice, particularly if that party happens to be the children. I believe that Section 2036(c) is an unworkable statute which has an unjustifiably negative impact on the transfer of family businesses.

I also urge that improvements be made to the payroll tax penalty system in order to alleviate the substantial and unnecessary burden this system imposes on small business. Finally, Congress should extend and expand the self-employed deductions for health insurance in order to promote health coverage in small firms and improve tax equity between small firms and corporations.

Senator BOSCHWITZ. I note that Senator Stevens from Alaska has come in. Senator, do you have any opening comments that you wish to make?

Senator STEVENS. No. Thank you very much. I apologize for being late, but I am very interested in this subject. That's why I came by.

Senator BOSCHWITZ. Thanks.

We will hold up our questions until Mr. Motley testifies, but it was good testimony.

Mr. SWAIN. Thank you, Senator.

Senator BOSCHWITZ. Mr. Motley, you might comment. I noticed in this morning's paper, since you have been very active, that Chairman Dan Rostenkowski of the House Ways and Means Committee has reversed his previous stand and said he now supports repealing Section 89. He reverses his stands from time to time I note. This one I certainly agree with.

STATEMENT JOHN J. MOTLEY III, DIRECTOR, FEDERAL GOVERNMENTAL RELATIONS, NATIONAL FEDERATION OF INDEPENDENT BUSINESS, WASHINGTON, DC

Mr. MOTLEY. My understanding on that, Senator, is that the Chairman had a meeting yesterday with several business groups, I believe some that will be represented here later in testimony, in which he not only indicated that he was going to reverse his position and repeal Section 89 in his new mark before the Committee, but that he was also going to continue 25 percent deductibility, which is one of the first things that I was going to talk about here.

We have not seen the language on it.

Senator BOSCHWITZ. Since he was in an expansive mood, did he say anything about the capital gains? [Laughter.]

Mr. MOTLEY. I think that is still being worked on. They have not decided that one yet. It appears that Section 89 and deductibility have paled in comparison to some of the other issues the Committee is going to face in its reconciliation bill.

Thank you very much for the opportunity to testify here today on not only Section 2036(c), but also a whole series of issues which are going to be before the Senate Finance Committee as they proceed with reconciliation. I think these hearings are tremendously timely and the Committee should be thanked and commended by the small business community for them.

The deductibility issue in itself is a perfect example. Up until yesterday, we were extremely fearful that we would lose 25 percent deductibility because the Chairman did not include it in his mark. It is now in his mark, and I understand that the Administration has also changed its position because it did testify before the Budget Committees that it was willing to let 25 percent deductability expire. Therefore, we feel fairly confident that deductibility for the self-employed will be continued.

I would like to join Frank and I think almost everybody else who has studied the problem of accessibility of health insurance to individuals in saying that there is absolutely no reason why Congress should not give the self-employed 100 percent deductibility for their health insurance premiums.

A recent NFIB survey indicated that there is a direct cause-effect relationship between the cost of health insurance and the ability or willingness of small employers to purchase it for their businesses and for their employees. Some work done by the Small Business Administration points that out clearly. In the one to nine employee category, only 30 percent of the self-employed individuals in this country—and self-employed by definition are over two-thirds of all the business tax returns filed in this country—only 30 percent of them provide health insurance for their employees. While 70 percent of the corporations do.

If you move to the 25 to 100 employees range, 44 percent of the self-employed provide health insurance, and almost 100 percent of the corporations.

Senator BOSCHWITZ. Would you say that again? Start that thought again. You say that 30 percent of the companies which are——

Mr. MOTLEY. Thirty percent of the companies, of the unincorporated businesses——

Senator BOSCHWITZ. Proprietorships.

Mr. MOTLEY. Proprietorships and partnerships in the one to nine employee category, purchase health insurance or provide it for their employees. Corporations in the same employee category—70 percent of them do.

Now, if you go to slightly larger firms, between 25 and 100 employees, 44 percent of the self-employed provide health insurance, while 96 percent of the corporations provide health insurance.

Senator BOSCHWITZ. How many employees?

Mr. MOTLEY. Twenty-five to 100 employees, Senator.

I do not think that there is any clearer evidence that incentives in the tax code provided to business owners to purchase health insurance work.

And if you need slightly more evidence than that, all you have to take a look at what has happened in this country from 1940 to the present day. In 1940, roughly 40 percent of the workforce were covered by private health insurance in this country. Today 85 percent or 84.7 percent are covered by private health insurance. That is, the business community has covered more and more of the total population of this country over the last 45 to 50 years.

So, therefore, I think that we would like to make a very strong appeal for the Small Business Committee to support not only the retention of 25 percent deductibility, but also going to 100 percent deductibility. As Frank indicated before, some one-quarter of Senator Kennedy's total of uninsured people in this country are self-employed, and they employ 32 percent of the workforce.

Senator BURNS. Would you say that figure again?

Mr. MOTLEY. One-quarter of Senator Kennedy's 37 million uninsured individuals in this country are self-employed.

Senator BOSCHWITZ. And what percentage of the uninsured are the employees of those people?

Mr. MOTLEY. That is a much more difficult figure to get at. We do know those people employ 32 percent of the total workforce. And I think as a businessman yourself, Senator, if you had the incentive to go out and purchase health insurance and with the antidiscrimination rules that we are trying to put in the tax code, that

when the employer goes out and purchases health insurance, be it for his own reasons, he is also going to purchase it and provide it for most of his employees. So, that is a tremendous first step in trying to deal with the problem.

Senator BOSCHWITZ. Well, that would be very helpful if you could establish the second part of that, what percentage of the 37 million. I understand it is now supposed to be 31 million.

Mr. MOTLEY. It has dropped. Official estimates have dropped.

Senator BOSCHWITZ. What percentage of them, not only the employers, but the employees—if you could establish that, it would be very helpful.

Mr. MOTLEY. We will try to take a look at that.

Frank, do you know if such figures can be——

Mr. SWAIN. It is a little bit difficult statistically to get, Senator, but we will supply the Committee with the evidence that is available from HHS and others.

Senator BOSCHWITZ. Please do provide that.

[Material follows:]

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF CHIEF COUNSEL FOR ADVOCACY

October 25, 1989

Honorable Rudy Boschwitz
Committee on Small Business
United States Senate
Washington, DC 20510-2301

Dear Senator Boschwitz:

At the September 13th Small Business Committee hearing on the impact of current tax laws on small business you inquired about the number of self-employed and their employees. The question is significant because most self-employed neither purchase insurance for themselves, nor for their employees. If the limited deductibility under IRS Section 162(1) of 25 percent of a proprietor's personal cost for health insurance is not continued by the Congress, we will have eliminated he only tax incentive encouraging health insurance coverage of the self-employed and their employees.

Indeed, there are sound tax and health policy reasons not only for continuing that deduction, but for expanding deductibility to 100 percent. There are currently at least 8.6 million self-employed persons in the United States. These self-employed likely employ an additional 8.2 million workers. It appears that no more than 47 percent of the self-employed and their employees are covered by health insurance. Thus, the self-employed and their workers account for at least one of every four persons in the U.S. who do not have health insurance. The sources and methodology for calculating this information are described in the enclosed data sheet.

We know that inadequate profits is the principal reason small firms fail to provide health coverage. Obviously, the government cannot legislate adequate profits to provide health insurance for every self-employed individual. However, there is no tax policy or health care policy reason to deny full deductibility of health insurance costs to these individuals.

I congratulate you and the Committee for your interest in this issue and hope that you will urge the Finance Committee to take positive actions and extend this important tax law.

Sincerely,

Frank S. Swain
Chief Counsel for Advocacy

Enclosure

October, 1989

FACT SHEET ON SELF-EMPLOYED AND HEALTH INSURANCE

1. How many people are self-employed?

14.9 million
8.6 million unincorporated self-employed as principal occupation
3.0 million incorporated self-employed as principal occupation
3.3 million wage-and-salary workers who own a side business (moonlighters)

Basic statistics on the number of self-employed are derived from monthly Employment and Earnings data released by the Bureau of Labor Statistics. The number of principal unincorporated self-employed is available for 1989 from Employment and Earnings, while the number of incorporated self-employed and the number of moonlighters are estimated based on an SBA analysis of the 1982 Current Population Survey. Those survey results were projected forward using the 1989 Employment and Earnings figures.

2. How many workers (in addition to the owners) are employed in self-employed firms?

8.2 million workers employed in self-employed firms

This estimate is based on a forward projection of a 1982 IRS-SBA analysis of the number of employees of various business organization forms. The 1982 analysis concluded that sole proprietorships and partnerships together employed 7.1 million workers or about 6 percent of the nonprivate workforce. An analogous figure based on 1989 workforce size is 8.2 million. This does not include employees working for the incorporated self-employed or those working for moonlighters.

Number of Employees by Legal Form of Business, 1982
(Number in Millions)

Corporations	59.9
Partnerships	2.5
Sole Proprietorships	4.6
Non-Profits	7.4
Total	74.4

3. How many self-employed and their workers do not have health insurance?

8.4 million self-employed and their workers lack health insurance

According to data from the 1983 CPS approximately 54 percent of all unincorporated self-employed and 26 percent of the incorporated self-employed were not covered by either their own or another's health insurance plan. This leads to an estimate of 4 million uninsured self-employed who employ an additional 4.4 million uninsured workers.

Mr. MOTLEY. The second thing that I would like to touch on, Senator, is another element or topic that Frank brought up and that is the reforms in the penalty sections of the IRS Code that will be in the reconciliation bill. The House has made a good start in its bill, and I understand that Senator Pryor and his task force are going to make even better recommendations to the Senate Finance Committee in the area of penalties.

But one of the areas that is not going to be touched that is of great concern to us is the trigger on reporting requirements for FICA. Right now if you have more than $3,000 per month in deposits for FICA insurance, you have to report each time you make payroll. If you are under $3,000, you only have to report once a month. Those figures were put into effect in 1980.

This presents a real problem for an awful lot of small employers who do not have accounting assistance. Roughly one out of four small employers does not even have an accountant. They do their own books. Many of those who do, do not have the computers with sophisticated programs. It is almost like an old-fashioned speed trap out on a rural highway. If you fall above it, right away the next month you must report every time you meet a payroll. And the penalties are automatic if you miss, and sometimes they are very severe.

The $3,000 threshold, in our estimation, represents roughly 10 to 15 employees. So, you are not talking about a very large firm.

We would strongly suggest that you take a look at raising that trigger to somewhere in the neighborhood of $10,000 a month, which would be a firm, depending upon salary of the employees, somewhere between 20 to 30 employees, not a very large business. There is no revenue loss except in lost penalties and in timing.

Of all of the complaints that I receive about IRS, this is the one that comes up the most often, firms who unknowingly go over the $3,000 threshold and miss the filing deadline because their employee base is expanding rapidly, because they hire part-time help, or because they give bonuses at the end of the year. They go over it one month, and then the next month they are liable and the IRS catches them and that's it.

Senator BOSCHWITZ. That must be most of it I thought as I looked this—bonuses at the end of the year.

Mr. MOTLEY. Bonuses at the end of the year cause a real problem, or seasonal work, Senator, causes an awful lot of problems, too.

Quickly one other item, an item that you dealt with last week and that several of you spoke on the floor on, and that is the passage of S. 933, the Americans with Disabilities Act. Senator Boschwitz, the Chairman of the Committee, and Senator Bumpers, were actively involved in the debate at the time. A great deal of the discussion that took place on that piece of legislation was on ADA's impacts on smaller businesses.

Right now in the Internal Revenue Code there is a $35,000 deduction for businesses that make changes in their physical facilities to accommodate the handicapped.

Senator Hatch offered an amendment which would change that to a $5,000 credit for some businesses on the floor, and while a ma-

jority of 48 Senators voted in favor of it. It needed 60 votes because it busted the budget resolution.

Senator Dole then came to the floor and suggested that the Finance Committee was going to take a long, hard look at this in its markup of the reconciliation bill.

I think the idea of a credit, whether it be $5,000 or something less, is very important for the very smallest of firms which are going to have to comply with this law. Many small businesses and many newer businesses don't make profits. Therefore, they don't have any income tax liability. Therefore, the deduction is useless, worthless. And they still have to come up with the funds to comply with the law.

A credit makes a great deal more sense. And if the Committee would agree with that, we would hope that you would suggest to the Finance Committee that they look out for the smallest of firms and substitute a credit in this area rather than the deduction which is currently on the books.

Lastly, Mr. Chairman, I would like to deal with the subject that I think the hearing was primarily called on, and that is Section 2036(c).

I would like to go back to something more generic, and that is, I think that Congress has really got to take a look at the way it wishes to treat family businesses in this country and whether we want them to be passed on from generation to generation, whether we want them to continue, whether it is in the best interest of the United States.

I thought we settled that debate in 1981 when we passed a number of very significant changes, not the least of which was the $600,000 marital deduction. But then in 1986 we made a number of changes, not just Section 2036(c). We have made changes in the installment sales rules, general utility rules and a number of others which make it much more difficult for people who own family businesses to pass it on to the next generation.

So, I think that the real issue that this Committee can address and be very, very helpful to the small business community of this country on is to take a look at how the tax code deals with this entire area. And what you would have to ask yourself is whether we want to tax the transfer of a business worth $1 million the same as we want to treat $1 million in cash. From our standpoint, they are two entirely different things. One is liquid, the other is not. In order to become liquid, you have to sell the assets of the business, which destroys the business and some of the jobs that are there.

And we keep on making these changes around the edge every time we go into the tax code primarily to pick up a little bit of revenue, so that we can meet the reconciliation proposal. And we are having a dramatic effect upon the ability of a businessowner to pass on that business to the next generation. So, I really do think that is a more basic question.

Now, on Section 2036(c), Frank explained it well. I do not need to go over it, and you are going to hear people here who have much better examples of how it works than I can ever give you.

It was aimed at dealing with abusive situations, just as Section 89 was. But just like Section 89, you see IRS using a sledgehammer to get at the problem.

And what they have done is created tremendous uncertainty. We have a vague law. We have vague regulations out there. We have taken a look at a number of the solutions that have been offered, those by the ABA and by others, and we do not feel that they are adequate.

Our suggestion is to repeal it, and then we and the small business community will be more than happy to sit down with the Finance Committee, with Treasury, with Ways and Means and to find some way that we can deal with the abusive situations. That is what Treasury is trying to get at. We do not believe that they focus on abusive situations now, and that the only simple and quick answer is to repeal it.

One additional comment. If it is to be repealed, it is going to have to be done from the Senate side in this reconciliation bill. My understanding is that Mr. Archer, who has been very much out in front on this fight over on the House side, has been told by Treasury that they will vigorously oppose an amendment to repeal it on the House side. And with everything else that is going on over there, I do not think it would be wise for him to try to do that. So, it looks like it is almost going to have to be a Senate-led initiative at this point if it is to be done.

Senator BAUCUS. Mr. Chairman, if I might just add. I have to leave pretty soon.

John, I want to urge you to help us, frankly, in the Senate to try to get in the tax bill the increase on the limits—on the trigger for the payroll deduction—the payroll deposit because, as you recall, a few years ago—I guess 1985—I offered an amendment to raise those limits. And that was in the Senate bill. We got it adopted in the Senate bill, but they were dropped in conference.

Mr. MOTLEY. It was in the Social Security reform, wasn't it, that we raised that?

Senator BAUCUS. One was the Social Security reform, another was in the 1985 tax bill two separate times. Now, those limits were raised at a lower level, much lower than you are here now suggesting. I think they are only up to $5,000 instead of the present $3,000. Nevertheless, there was an increase, and the Senate did get that in the Senate tax bill. It was dropped in conference.

So, I'm urging you to work together with this Committee and myself and many of us here on the Finance Committee to get it back in the Senate bill, but at a higher level. We do have the precedent. That's right.

Mr. MOTLEY. There is an awful lot more support I believe on the House side for that this time. And the reason that limits are higher is because I believe if you simply adjusted for inflation, it would be up around $7,000 today.

One final comment, Mr. Chairman, and that is the general broad area of payroll taxes. We in this country since the 1940s to the present day have relied more and more and more on payroll taxes to raise revenue. Payroll taxes have a tremendously disproportionate impact on smaller businesses, No. 1, because we do not make a lot of money. Therefore, we do not have a lot of income tax liabil-

ity, but we have to pay the payroll taxes. No. 2, they have a tremendous impact on new business startups and job creation because whether you are making money or not, you have to pay those payroll taxes.

We did a little study back in 1980 which is probably dated now, but dated in the way we would probably want it, that roughly 80 percent of the tax liability of more than a majority of NFIB members was in payroll taxes, not in income taxes, not in property taxes, not in sales taxes, but in payroll taxes.

In addition, they are very regressive not only for the employer, but for the employee.

Therefore, anything that can be done to move the Congress off its path of increasing payroll taxes every chance it gets—you know, in the Ways and Means Committee just 3 or 4 weeks ago, Congressman Downey offered an amendment which would raise the wage base on FUTA from $7,000 to $10,000 to pay for a whole host of other programs.

So, payroll taxes appear to be an easy target because business owners pay it and it's one that concerns us a great deal. And this Committee could do a real service to the small business community if you could help us convince the Finance Committee Members and Ways and Means Committee Members of their importance.

Thank you.

[The prepared statement of Mr. Motley follows:]

NFIB
National Federation of Independent Business

STATEMENT OF

JOHN J. MOTLEY III
DIRECTOR
FEDERAL GOVERNMENTAL RELATIONS

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Before: Senate Small Business Committee

Subject: Small Business Tax Concerns

Date: September 13, 1989

Mr. Chairman, my name is John Motley, and I am the Director of Federal Governmental Relations for the National Federation of Independent Business. NFIB is the nation's largest small business advocacy organization, representing the interests of more than 570,000 small and independent business owners throughout the country.

I want to thank you for giving me this opportunity to testify before your committee on several tax issues that are of great importance to the small business community. As you are aware, small businesses are on the front lines of our economy, and even very slight changes in the tax code can have a devastating impact. NFIB truly appreciates your efforts to emphasize the tax code's effect on small business.

HEALTH INSURANCE DEDUCTION FOR THE SELF-EMPLOYED

Under present law, the tax code distinguishes unjustly between corporations and sole proprietorships and partnerships. Corporations are allowed to deduct all of their health insurance costs including that of the owners. Sole proprietors are only allowed to deduct fully the health insurance costs of their employees. The owners themselves are allowed to deduct only 25 percent of their health insurance costs.

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According to a study by the Employment and Benefits Research Institute, over 22 percent of self-employed business owners are not covered by insurance. These business owners make up approximately 7 percent of all uninsured workers and employ 32 percent of the American workforce.

The Guardian of Small Business

In Congress' efforts to address the problem of the medically uninsured, they should begin by offering a fair tax deduction to the self-employed because there is a clear cause/effect relationship between the affordability of health insurance and the willingness and ability of a small firm to purchase it.

Small business owners support increasing the number of people covered by health insurance. In fact, a study conducted by the NFIB Foundation this year found that 71 percent of small business owners believe that every American has a right to basic health care. The study also uncovered another fact that should not be much of a surprise -- whether or not a business offers health insurance depends on that business' profitability. Small businesses do not buy health insurance they cannot afford. Allowing the business owner to deduct 100 percent of their own health insurance costs would be a big first step in making health insurance affordable.

Surprisingly, even the 25 percent deduction for health insurance is at risk. This deduction will expire at the end of this year, and the Ways and Means reconciliation package does not contain its extension. At a bare minimum, the 25 percent deduction should be extended.

NFIB strongly supports efforts to equalize the corporate and self-employed deductions for health insurance. Self-employed individuals should be able to deduct 100 percent of their health insurance costs for two reasons: (1) it provides an incentive for the business to set up a health insurance policy for all the employees; and (2) it provides an offset against the increasing costs of providing health insurance.

FICA REPORTNG

The threshold level for monthly deposits of payroll taxes is also of major concern to small business. Current law provides that if total monthly withholdings do not exceed $3,000 (this represents a business with approximately 7-10 employees), the taxpayer can deposit monthly. If withholdings exceed $3,000, the taxpayer must deposit with each payroll, up to eight times a month. These thresholds were set in 1980 and are out of date, forcing many smaller employers to deposit withholding taxes more than once a month.

This system is a nightmare of paperwork for small firms because they tend to have less access to professional assistance, and they tend to be more labor intensive. Their compliance burden is compounded because many do not have a computer system to calculate payroll deposits, but instead must rely on calculators and adding machines. Severe penalties are levied on small firms that fail to comply.

Many small business owners believe that low thresholds and the penalties associated with them are being used as revenue-raising measures and not simply to foster increased compliance with the tax laws. Payroll tax penalty revenues constituted 23% of total net tax penalty revenues last year. By far, the vast majority of the complaints against the IRS that NFIB receives relate to penalties imposed for violations of deposit rules.

In addition, these thresholds do not account for the seasonal activities of a small business. For instance, a small business that specializes in landscaping may be required to hire more employees during the summer months and therefore may exceed the $3,000 threshold while not coming close to the $3,000 mark for the remainder of the year. The same argument may be used for employers who give holiday bonuses to their employees at certain times during the year and therefore will pass thresholds for those months but not in any other.

Once an employer crosses that $3,000 threshold, he or she must deposit with every payroll, starting the next month. It is very easy for an employer not to realize the $3,000 threshold has been crossed until after several deposit dates have already been missed. Penalties are automatic and many times severe.

In all, increasing the threshold levels from $3,000 to $10,000 (firms with approximately 20-30 employees) would not reduce tax collections (except for penalties); it merely shifts the timing of collections. This adjustment would, however, be of tremendous benefit to small businesses by reducing paperwork burdens and making compliance less cumbersome.

TAX INCENTIVES FOR COMPLIANCE WITH THE AMERICANS WITH DISABILITIES ACT

Last week, the Senate passed S. 933, landmark legislation to help bring the nation's disabled into the mainstream of American life. Much of the debate that occured on the Senate floor revolved around the financial burden compliance with S. 933 would put on smaller businesses.

Section 190 of the Internal Revenue Code allows businesses to take up to $35,000 as a tax deduction for structural changes that would make their business premises more accessible to the disabled. Senator Hatch attempted to expand this definition during Senate consideration of the Americans with Disabilities Act (ADA) to include other physical changes to businesses as well as other aids and accommodations.

On a subsequent amendment, 48 Senators voted in favor of allowing smaller businesses to take a $5,000 tax credit instead of the deduction. The credit was proposed because smaller businesses do not have enough taxable income to take full advantage of a deduction. Offering these small businesses a tax credit would give them incentive to participate in making their businesses more accessible to the disabled.

If Congress is going to require small businesses to bear the burden of responding to the needs of the disabled, some type of tax relief must also be included. Small businesses should not be expected to bear the societal burden created by the ADA.

ESTATE FREEZE – SECTION 2036(c)

An estate freeze can be an extremely useful tool in the struggle to preserve family owned businesses. It allows small business owners to pass along their life's work to their children while remaining involved in the business at some level. Estate freezes allow the business owner to "freeze" the value of the business at the time that control over it passes to the next generation.

The Problem

The tax code provides no logical way to transfer a business from one generation to the next. Section 2036(c) makes preservation even more difficult because it prevents most estate freeze transactions. Section 2036(c) denies parents the option of gradually transferring control of the business to their children.

Without a freeze, any appreciation in the value of the business that occurrs during the parent's lifetime can be added back into their estate upon death. This is true even if most of that appreciation is not due to the work of the parent but to the work of the children. For example, without an estate freeze you could have the following scenario:

> Mrs. Smith buys a grocery store in 1940 for $40,000. In 1970, the value of the grocery store has increased to $250,000, and she passes ownership of the store to her son. Mrs. Smith dies in 1988, and the store is now worth $1.5 million. Without an estate freeze at the time the store is passed from Mrs. Smith to her son, the increased value of the store from the time she purchased it to the time she died ($1.46 million) would be added back into her estate. And her son would have to pay the estate tax. Using an estate freeze, NO tax would be due. Her son would inherit only her $250,000 share of the business, and because this falls beneath the $600,000 exemption on inheritance taxes, no tax would be owed.

The children of business owners should only have to pay estate tax on what they inherit from their parents. The problem lies in figuring out how to determine upon the death of the parent what portion of the value of the business is due to the parent's work and what part is due to the work of the children.

An estate freeze allows the children to avoid paying taxes on the increased value of the business that is attributable to their own hard work by creating a point in time before which the value of the business is the parent's and after which any increase in the value of the business is the children's.

In Mrs. Smith's case, the value of the business was clear. Unfortunately, in many estate freeze cases the value of the business at the time of the freeze is hard, if not impossible, to determine. Section 2036(c) was drafted in response to what the tax-writing committees perceived as abusive valuations of businesses at the time of the freeze.

The problem for small business owners is that Section 2036(c) is very vague. Vague laws are not unheard of in Washington, but this vague law creates a REAL problem.

The problem is the portion of the business that will be added back into the parent's estate is not determined until the parent's death. In other words, the heir could find out upon the death of the parent that the estate freeze the parent performed did not fall within 2036(c)'s confusing definition of a "freeze" and the value of the business could be subject to the 50% estate tax. Very few businesses will be able to survive this tax.

Section 2036(c) could well be labeled the son of Section 89. Like Section 89 it employs a sledge hammer approach to solve a relatively minor problem.

The Solution

Repeal it.

Section 2036(c) is so complex and its effects so broad that NFIB is convinced that outright repeal has to be the first step in any workable solution. The compliance problems 2036(c) was designed to alleviate may be addressed in a number of different ways, but any solution to 2036(c) will have to begin with repeal.

The second step in solving the problems created by Section 2036(c) is more difficult. Congress must clarify what its policy goals are regarding estate freezes. Until a clear line is drawn outlining what estate freezes can and cannot do, it will be extremely difficult, if not impossible, to determine what an abusive estate freeze is.

Estate freezes are a valuable tool for small, family businesses. They allow a family business to clearly identify the point at which the children have taken over. The problem with current law is that it prohibits the use of an estate freeze in a wide variety of common family business practices -- such as the parents loaning the children money at the time of transfer.

Does Congress want families to pay a 50 percent tax on business assets? There is a big difference between inheriting $500,000 in cash and inheriting the family business worth $500,000. Does Congress want the tax code to treat the transfer of the family business from one generation to the next exactly the same as the inheritance of $500,000 in cash? These questions need to be answered before Congress goes in search of a solution to 2036(c).

Some solutions put forward to fix Section 2036(c) include a safe harbor that would allow the business owner to conduct an estate freeze as long as a certain portion of the business is considered a gift to the younger generation and taxed as such. For example, one proposal to reform Section 2036(c) forms a safe harbor for business owners that declare that at least 20 percent of the value of the business is being given as a gift. In Mrs. Smith's example, this would mean that she would have to add $40,000 to her taxable income. [20 percent of $250,000 is $50,000 minus the $10,000 gift tax exemption equals $40,000.]

NFIB is very concerned that this type of solution will price estate freezes out of the reach of some small business owners. A small business owner should be able to transfer the future appreciation in a business to the next generation without it being subject to devastating estate or gift taxes.

NFIB's basic concern is that a small business owner be able to pass along the family business -- in one piece -- to the next generation. If a substantial part of the business is subject to estate tax, some or all of the business will have to be sold to pay the tax. NFIB strongly believes that family businesses have played a vital role in the economic development of our nation, and the tax code should not discourage the continuation of family businesses by hitting them with a tax so high that the business will have to be sold after the first generation.

Section 2036(c) was drafted in response to what were considered to be abusive uses of estate freezes. Parents were not correctly valuing what they were transferring to their children. They were giving their children more than they reported. There are several ways to address the problems of valuation associated with an estate freeze that are not as draconian as Section 2036(c). Section 2036(c) should be taken off the books until these other options can be explored in greater detail.

PAYROLL TAXES

Payroll taxes have a particularly devastating impact on small businesses that are just starting and are struggling to become profitable. Income taxes are based upon how much the business earns each year. Payroll taxes, however, are regressive, ignoring the ability of a business or individual to pay. Since small businesses earn very little in the first few years and are usually labor-intensive, payroll taxes are disproportionately burdensome to them. In fact, a 1980 study of small business tax burdens determined that the burden of payroll taxes exceeds 80% of a small business' total tax burden in many cases.

The payroll tax burden can be this high because the taxable income of many small businesses is very low in their first couple of years, and their income tax liability is correspondingly low. A recent study by the NFIB Foundation has revealed that almost half of all new businesses are started with less than $20,000. A business with this little start-up capital will probably have to pay a minimal amount of income tax, but the payroll tax liability will not be reduced because of low profitability. In fact, it is not reduced even if the business loses money.

From 1946 to the present, payroll taxes have represented a steadily increasing percentage of federal revenues. In 1946, payroll taxes were approximately 7 percent of all federal revenues. In 1982, they represented over 32 percent. Payroll taxes have become a very attractive way to raise revenue because a large portion of the revenue comes out of the employer's pocket.

The darker side of payroll taxes is rarely discussed. An employer only has a limited amount of funds that can be used for the business' payroll. If a large part of those funds go to payroll taxes, that employer just hires fewer people or invest less money in the business. The costs of payroll taxes on society, in terms of unemployment, are enormous. Payroll taxes are a tax on jobs.

Any reduction in payroll taxes would boost the number of new business starts, because these levies are a difficult hurdle over which an entrepreneur must be able to leap before a business can be started or grow. Reducing the size of this hurdle will make it much easier for entrepreneurs to start their own businesses.

Payroll taxes continue to be popular, however. During the debate on this year's reconciliation bill, the House Ways and Means Committee defeated a proposal to increase the wage base for the federal unemployment tax by only one vote. The revenue from this increase would not have been used to fund the unemployment compensation system; it would just have been added to the general revenues. This type of budget financing by Congress would be particularly hard on smaller, more labor-intensive firms, and we hope the committee would actively point this out to their colleagues in the Senate.

In conclusion, payroll taxes of all types are a major hindrance to new business starts, and because of their hidden nature and disproportionate impact, they are bad tax policy. The 0.2 percent temporary surtax on federal unemployment insurance should be repealed because it is a burden to small business growth and it is no longer needed to provide to increase the trust funds. Additional efforts should be undertaken by the Committee to reduce the payroll tax burdens on our nation's employers.

Again, I want to thank the Committee for giving me this opportunity to testify on a number of tax issues that are of great importance to NFIB's 570,000 members. I hope you will not hesitate to contact me again in the future if you need any further information regarding the effect of tax provisions on small businesses.

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Senator BOREN. Thank you very much. I certainly say amen to your last statement.

And it is ironic to me that some of those who scream the loudest about progressive taxation, who say, oh, we ought to up the top rate and all the rest of it to make the system more progressive, are the very people who advocate huge increases in what are really regressive payroll taxes, as you say, that really also not only impact the employee, but it really impacts the small business in such a devastating way. And it is an irony to me that—and as the percentage of the total tax burden, they have been growing rapidly—that the very same people who scream so much about rates on the income tax side are strangely silent when it comes to talking about the payroll taxes.

Let me mention that Senator Harkin was here. He is in a markup in another Committee.

We have also been joined by Senators Grassley, Pressler, Kasten, and Stevens. We are happy to have all of you join us.

STATEMENT OF HON. TED STEVENS, A U.S. SENATOR FROM THE STATE OF ALASKA

Senator STEVENS. Mr. Chairman, I have to go to that same markup. Could I interrupt you just one minute?

Senator BOREN. Surely.

Senator STEVENS. I came by particularly to try and get on the record and urge the Committee, and maybe the witnesses have some comment. My attention was called to several provisions in the House version of the tax bill that are very oppressive as far as some small businesses are concerned.

For instance, there is a provision in there that would repeal as of July 13, the offset against taxes on the State for the carrying out of an ESOP plan. I do not know if that has come to your attention, but I really think it is quite unfair to the situation—and I know of one in my state where a person has now just passed away who had an ESOP that was in effect in his small business for over 10 years. And now this provision would repeal that offset as of July 13. There is no chance to change the plan. The plan has to be carried out, and it does away with the very incentive for maintaining local ownership of small businesses.

And I think too often we just go to sleep on these provisions that suddenly just kick in on the small businesses and cause chaos and force the survivors to sell the small business to national concerns. We lose local control of small businesses because of tax provisions.

I am pleased to hear Mr. Motley's comment about Section 89. I would urge this Committee to have someone take a real good look at that version of that tax bill and see what it is going to do to small business.

Senator BOREN. I think that is a good point and one of the things I think we should consider doing. I will discuss this with Chairman Bumpers as well.

I think it might be a very good thing for this Committee by letter or some appropriate means to alert the Finance Committee to some of the proposals that might be pending, especially as they are coming over from the House. Without trying to pass the buck, that

is where we have had the problems in conference in the past on these items affecting small business. But we really need to make sure that the Finance Committee—we have some cross-over Members, myself and others on this committee. We ought to have them alerted so that we are not falling asleep at the switch.

Senator STEVENS. I would join you on that.

Senator PRESSLER. Mr. Chairman, on that point, could we adopt resolutions or could we adopt a position for repeal of Section 89 and Section 2036(c) as a result of this hearing and the things we are doing? Rather than just alert them, can we actually have a rollcall vote on some of this and send it to the Finance Committee? What is the proper mode of communicating our position on these sections?

Senator BOREN. We couldn't today because we have just notified Members that this is a hearing. That would be done by the full Committee. But after the hearing is over with today, I certainly will sit down with Chairman Bumpers, summarize for him the feelings that we have heard today, which seem to me to be a broad cross section. I said earlier I wish we could vote today and that our vote would be binding on the Senate because we have the right attitudes being expressed.

Let's see if we can't get some sort of an expression out of the Committee, especially from the Finance Committee. I know that Chairman Bumpers is very interested in this whole area as well. Senator Boschwitz is the Ranking Member on your side of the aisle on this Committee, and we will discuss this with him and see if we cannot get some sort of an appropriate expression because we need to make sure that the Senate conferees are going to conference with our resolve stiffened because we have had these things slipped in in conference from the House side from those that are basically hostile to small business and I think we ought to be on the alert.

Mr. Motley.

Mr. MOTLEY. Senator, after you pass a tax bill like that, it generally takes us 3 to 4 months to figure out where its problems are. The last bill was how many thousands of pages long? And Section 89 was something that was not even in the sights of anybody except a few benefits people who were working the bill at the time.

Senator BOREN. And classic over-reaction to a small amount of abuse to go in and do what was done. As you know, we have made some very major changes in Section 89 that are tacked onto the vehicle coming out of the Senate. Who knows what will happen to that vehicle. If not, why, I think many of us are intent on getting something—we'll put it back on reconciliation or someplace else till we get some relief on it.

Let me just ask one brief question and then we will just go in order of questioning.

Senator Levin has also joined us, and then those who have come in since, if there are any opening comments they would like to make as we go into the questioning round.

Let me just ask one question. Do either one of you feel that Section 2036(c) could be fixed or modified in some way with some kind of replacement or modification, or do you think that the only solution is repeal?

Mr. SWAIN. When I look at the section, I do not feel that Section 2036(c), as it is constituted, can be repaired using that as a basis.

Let me back up one step before that. I do not know who has made a case that there are such number of abuses under this type of practice that legislation is necessary. But if, perchance, someone can indeed make that case, if there are some abuses, then maybe there are some remedies that would be appropriate. Maybe we need to tighten laws on reporting of valuation at the time the transfer is made.

So, to answer your question, Senator, I think it cannot be fixed. Whether it can be replaced by something that takes an entirely different tack, I think there may be a case to be made for that.

Senator BOREN. Maybe strengthening the reporting requirements of valuation at the time, but then not going into the rest of it.

Mr. SWAIN. Yes.

Senator BOREN. Thank you very much.

We will go to Senator Boschwitz, then to Senator Wallop, Senator Pressler, Senator Kasten, and Senator Levin.

Senator BOSCHWITZ. We have nine witnesses, Mr. Chairman, so we really ought to move along as quickly as we can.

I think most of the questions have been covered that I would ask.

I would say that I have a bill that will raise the FICA threshold to $10,000 and will see to it that it is indexed.

Mr. MOTLEY. A wonderful idea.

Senator BOSCHWITZ. It has not yet been introduced. I will talk to some of my colleagues.

I see that I am on the Symms bill which is currently similar to the Boren-Daschle bill, and I would be very happy to join the Boren-Daschle bill as well.

One of the most interesting things, I would say to my colleagues and to the Chairman who I think was out of the room at the time that the testimony was given, was that of the 31 million people who are uninsured—apparently that is the new figure—in this country for health insurance—not 37 million, but 31 million, whatever the number is—25 percent are self-employed. And by giving the 100 percent deductibility, perhaps the largest share of the premium as a deductible item, we could perhaps reduce that number very substantially.

Thirty percent of the companies with one to nine people that are proprietorships and not incorporated have health insurance. Seventy percent of the companies that are incorporated, have one to nine people, have health insurance, so that those 30 percent of the companies cannot deduct the premiums. Well, they can deduct the premiums I presume for their employees.

Mr. MOTLEY. For the employees, but not for themselves. And the incentive, of course, is to cover yourself and your family.

Senator, notice that neither Frank nor I made the equity argument. We think that is obvious. What we have made are public policy arguments in the area of health care which is something that we in the small business community are terribly concerned about.

Senator BOSCHWITZ. Incidentally, on the floor of the Senate, I said that I would ask the Chairman of the Committee if we could have some hearings on the impact of the Disabilities Act because

we really did not have an opportunity to look at that beforehand, and we will do that. We will ask the Chairman. I am sure he will agree.

I did not quite understand your comment about Senator Hatch's amendment. That was a credit to replace a deduction?

Mr. MOTLEY. I do not know if he would have——

Senator BOSCHWITZ. That would be added to the normal deduction.

Mr. MOTLEY. What Senator Hatch's amendment would have done, if my understanding is correct, would have been to provide a very targeted $5,000 refundable tax credit to smaller businesses—and he defined smaller businesses in the amendment—in place of the $35,000 deduction which is currently in the code based on the argument that the very smallest of businesses are not likely to have the taxable income to offset the deduction. And yet, they are going to have to make the changes.

Senator BOSCHWITZ. I do not understand why that deduction is limited, but I will take that up with my staff rather than here today.

Senator BOREN. Senator Wallop.

Senator WALLOP. Thank you, Mr. Chairman. I just have a couple of observations.

You in your State, Max and Conrad in theirs, there a lot of us who have rural based economies. One of the things that is always an issue is how do you keep the young people in the State. How do you provide for them to have a living? Congress is pained to make certain that that remains an impossibility.

It has been my experience after a decade on the Finance Committee that Treasury has an inherent anti-small business attitude. I do not think it is necessarily something that they sit down and contemplate at night. It is just easier to be anti-small business, to raise revenue through a series of small proposals rather than a larger proposal hitting major industrial or corporate segments of our economy.

Frank, you said correctly you do not know anybody who has made the case that these abuses exist to such a dimension that this kind of a result was necessary. The problem is nobody is ever required to make a case.

I recall all those little meetings that we have to try to resolve the differences between the House and Senate. It always comes down to a whole package of little things that this will raise $500 million or $80 million or some other kind of thing. And the consequences are never explained, and the case for them is never made. It is only the case that they will raise that certain amount of revenue.

Congress itself responds to that because it is just a damned sight easier. You do not have to confront Goochie Gulch. It is simply simpler at the close of a House-Senate conference to pluck off the plums labeled $80 million, $100 million, $120 million, than it is a plum that would represent the sum total of those millions on a larger segment of the economy.

The health insurance figures done were absolutely fascinating.

The other thing that comes to mind just instantly is that on the one hand we have this major effort to mandate employee benefits,

and on the other hand, we have a major tax effort to discourage the provision of them. It's as though social engineering is a more acceptable form of legislative pastime than to try to induce a certain behavior that makes logical and consistent sense throughout the rest of our behavior.

With regard to the Disabilities Act, I am absolutely certain that I have never seen a piece of legislation go through Congress, the managers of which knew less about its consequences or less about its details than that piece of legislation. I was one of whatever it was, seven, who voted against it. But I believe that we are going to find a whole passel of Section 89's, Section 2036(c)'s and other similar kinds of consequences to that act.

And one of the other things I'm absolutely certain of is that whether the Hatch amendment were to have passed or failed—I understand the reasons for it—by providing those kinds of things, you skew how Americans react in their economy. In other words, at some moment in time it is going to be a damned sight better to stay a smaller business than to become a small business and then become a big business because you are going to be forced by the constraints of us to do these things.

I really welcome both of your testimony here this morning. it is articulate. I wish somehow or another we could get the rest of the Congress to hear it. I think that is our job to try to see to it that they do.

Senator BOREN. Thank you very much, Senator Wallop. I couldn't agree more.

Senator Kasten.

STATEMENT OF HON. ROBERT W. KASTEN, JR., A U.S. SENATOR FROM THE STATE OF WISCONSIN

Senator KASTEN. Mr. Chairman, thank you.

Today is a banner day for small business on a whole number of tax issues. If you read the papers this morning, we have a number of breakthroughs. I am sorry that I didn't have a chance to listen to the testimony of Frank and John, but what has happened today is due largely to them. There are no two people who have done more, one on the outside and one on the inside. And the Office of Advocacy is the right role for you, Frank. You have given us straight answers. We have been through colloquies on Section 89 I guess three or four different times. And remember, the last time we were talking about the mush we were getting from three or four other people, and you simply stood up and said it ought to be repealed. And I think it is very, very important.

But we see now a number of different kind of pro-growth small business initiatives, and I am just very, very pleased. The Ways and Means Committee is now supporting the repeal of Section 89. That point in and of itself is astounding—not reform, not fixing it, not working around the edges. No one has worked harder for that than NFIB, leading that effort, John, and we thank you.

The Committee has also agreed to extend the 25 percent deductibility for self-employed health insurance premiums. We are going to try to continue to push for more, with S. 1381, working with the

Coalition for Health Care Equity. NFIB is a part of that coalition. I know it has strong support in the small business community.

We have a number of other pieces of legislation. I understand that Senator Bumpers has an 80 percent deduction. My bill S. 1381 is a 100 percent deduction. I am joined by Mr. Harkin, Mr. Boschwitz, a number of other of members of this committee to go to 100 percent. And I think that we can do it.

We are going to vote to repeal Section 89 quickly. If we could do it in the transportation appropriations bill, we ought to do it.

Mr. MOTLEY. Do you mind if we wait till we see the Chairman's language? [Laughter.]

Senator KASTEN. We also want to look and see what the Dorgan proposal is exactly.

But right now we have had three or four votes in the Senate. They have all been close, one or two very close votes. But the fact is whether it is 10 percent withholding on dividends on savings, whether it is Section 89, whether it is catastrophic health care, whether it is a number of these other estate issues that are here, whether it is deductibility, the Finance Committee and the Ways and Means Committee simply cannot stand back when America is clearly in opposition to what they are doing and what they are doing doesn't make sense.

And I think that we are seeing a change. Yesterday Senator Bentsen introduced a proposal to expand IRAs. They have been proposed in the last three Republican platforms. This is another issue that small business has been interested in. And I think that Senator Bentsen's IRA proposal will help and compliment a capital gains tax cut and that both will encourage savings, investment, small business formation, and economic growth. And the fact is we can afford these proposals because the revenue gain from a capital gains tax cut will more than offset the static cost of expanding IRAs.

So, we have made great progress and it is due in no small part to the work that you are doing.

I do not have a question. I simply wanted to make that statement, and I look forward to the testimony of a number of these people, although I too am going to have to go to another meeting.

I thank and congratulate both of you for the tenacious work that you have done. And it is important that we have not just an Office of Advocacy, but an advocate. And I really appreciate the hard work that you have been doing and both of you have been doing.

Mr. MOTLEY. Thank you, Senator.

Mr. SWAIN. Thank you very much.

Mr. MOTLEY. Senator, I think we really do have to thank Senator Kasten too for all of the work that he has done. Almost everybody on this Committee has helped in some way or another, but the person who has stoked the fires over the last couple of months to keep the issue before the Senate is Senator Kasten, and we in the small business community owe you a great deal of thanks. Thank you.

Senator KASTEN. Thank you.

Senator BOREN. Senator Levin.

STATEMENT OF HON. CARL LEVIN, A U.S. SENATOR FROM THE STATE OF MICHIGAN

Senator LEVIN. Thank you, Mr. Chairman, and thanks to the initiative that you are taking in proceeding with this hearing this morning. It is important what you are doing. It is something you have always done, which is to show a real interest in the wellbeing of small business in America. And we are all in your debt.

I am pleased to be here today, Mr. Chairman, at least for a few moments—I have to go to a drug hearing in a few moments, so I am going to miss the next panels, but at least for a few moments to hear the concerns that have been raised about a number of our tax laws, including Section 2036(c).

I have received complaints from many of my constituents who feel that Section 2036(c) particularly is an unfair burden on those who work hard all of their lives to pass on a business to their children. The section is not only creating that burden, but it is also overly complex.

When I look at the controversies which have arisen over Section 2036(c) and over Section 89 and over the catastrophic health insurance, I think that the broader message to Congress and the Administration should be that our actions have consequences in the real world and that real people have to implement this abstract language that we pass around here. We frankly have enough problems in this country and in the world that we should be trying to address without enacting legislation in 1 year, only to have to enact remedial legislation in the next year or two. Our track record is not particular enviable in this regard, and we have to work on a great deal of tax legislation in the months ahead.

It is a sober warning to all of us about the dangers of a complicated, quick-fix, tax legislation or tax legislation that is attractive at first blush, but which in the end may make all of our faces red with frustration.

I am sorry for a number of reasons that I must go, one of them being that a constituent of mine, Lyda Nickell, will be testifying a little bit later. She sums up the concerns of many of us in her testimony in one paragraph in particular when she says that proper taxes should be paid, but the forced selling of a business simply makes no sense for the future well-being of the business, if it even continues to exist, its employees or the country.

Again, Mr. Chairman, thanks for your initiative.

Senator BOREN. Thank you very much, Senator Levin. We are glad you could be with us this morning to express your concerns.

Senator Pressler, any comments that you would like to make?

STATEMENT OF HON. LARRY PRESSLER, A U.S. SENATOR FROM THE STATE OF SOUTH DAKOTA

Senator PRESSLER. Well, Mr. Chairman, I think everything that has been said I agree with. I do hope that this Committee will adopt a formal position on the outright repeal of Section 89 and Section 2036(c), and send it to the Finance Committee, or that we have a formal resolution on some of these other tax matters that come before us.

I also want to join in saying that I think NFIB has done an outstanding job. I always refer to it in my speeches in South Dakota to my groups of small businessmen in terms of NFIB's highlighting these issues and providing leadership for small business.

I look forward to hearing further from the witnesses.

Senator BOREN. Thank you very much.

I think Senator Levin had one brief question before he has to depart.

Senator LEVIN. Thank you, Mr. Chairman.

I just had one question of Mr. Swain before I go. I know you are not here officially representing the Administration's view, but do you know what the position is of the Administration on Section 2036(c)?

Mr. SWAIN. I believe that the position of the Administration, or at least of the Treasury Department, is that they are willing to talk about Section 2036(c) because they are not entirely satisfied with the law and the workability of the law as it stands now. I do not know where on the long continuum of being willing to talk or being willing to change the law or being willing to accept a delay in the law—I do not know where exactly they stand. They do admit I think that they do not quite know all of the ramifications of what was put in the law in 1987 and 1988, and I think that they would welcome the opportunity to take a longer look at it.

Senator LEVIN. I was just wondering, Mr. Chairman, if it is our plan to ask for an official position of the Administration. I think it would be helpful.

Senator BOREN. Yes, we will. And also, do you know if we have a revenue estimate from them in terms of repeal?

Mr. SWAIN. I believe that there is a revenue estimate. It is cited in my statement and it is certainly less than $500 million over 7 years. It is really tiny in the first couple of years, $2 million, $4 million, $10 million, and then it goes up quite a great deal.

Senator KASTEN. Mr. Chairman, my guess is, if you will excuse me, that that revenue estimate would be about as good as the revenue estimates we have gotten on Section 89——

Senator BOREN. And catastrophic health, and so on.

Senator KASTEN. Yes, that we've gotten on catastrophic, about as good as the estimates we had on 10 percent withholding on interest and dividends.

What Malcolm Wallop said is right. This is a group of little kinds of things along with some tax court cases that they have lost, and they dump this thing in order to make it balance out every year, and then we have to take it all back out.

Senator LEVIN. I hope you won't prejudge the Administration. Maybe they can be supportive here, and I think we ought to get the Administration position officially.

Senator BOREN. We will request it.

Senator WALLOP. If history is any guide, though, the closer you get to repeal, the greater the revenue estimate. [Laughter.]

Senator BOREN. Exactly right. As I said in my opening comment, it always amazes me when something is imposed, they give a revenue estimate of how much it will raise. Then when you start talking about repealing it, why, you are going to lose four or five times

as much as they ever said you were going to raise. So, these are manipulated.

Senator LEVIN. I do not have a lot of confidence in revenue estimates either, frankly, but what I would like to know is what their position is regardless of the reliability of their revenue estimate.

Senator BOREN. Right.

Senator LEVIN. I do not even care if we get the revenue estimate because I do not put a lot of confidence in it either. I just want to know what their position is.

Mr. SWAIN. I think they are open to discussion on it, but that's as much as I would feel comfortable in saying.

Senator BOREN. We will seek that, and there are going to be some of us, of course, making a real effort to take care of this in the reconciliation bill when it comes through in the Finance Committee mark.

Mr. Motley.

Mr. MOTLEY. Mr. Chairman, I probably should not leave without alerting you to one other tax issue that you may be hearing a great deal about, especially the Senator from the beer State of Wisconsin, Senators from rural States.

Apparently the Bureau of Alcohol, Tobacco and Firearms recently has decided to try and collect a tax which has been in existence since 1866 on purveyors of spirits that has not been assessed or collected by the IRS up through 1988. And there are small business people out there, particularly those who do not sell it as a full-time business, but those who provide it as a service. Even some of your public service clubs or people who run little bait and tackle shops and they sell cases of beer, they are getting tax bills for $6,000, $7,000 $10,000 all going back a number of years.

And the bureau is very aggressively trying to collect this. Right now it is probably a good 25 percent of all the complaints we are getting in the tax area are just from that one single thing. So, you might want to take a look at it when the Finance Committee sits.

Senator BOREN. Thank you for mentioning that. That is a new one I hadn't heard before. Thank you.

Mr. SWAIN. Senator Boren, may I add just one thing and that is I want to state clearly for the record that although I am not here officially representing the Administration, the Administrator of the SBA, Susan Engleiter, has a very great interest in these tax provisions. And I know she has discussed them and is discussing them with the Treasury Department and to do her best, as well as my office, to try to get some changes made.

And I also want to state that I appreciate the courtesies that you and the other Members of the Committee have shown me over the years. Thank you.

Senator BOREN. Thank you very much. We will try to strengthen your hand in the bargaining process, some of us, in talking to Treasury and others and be making every effort.

Let me now call your second panel forward. Our second panel is composed of Mr. Tom Goodner of Goodner's Supermarkets in Duncan, OK. He is representing the National Grocers Association and the Small Business Legislative Council. Mr. Roy H. Hunt, president of the Hunt Tractor Co., Inc. of Louisville, KY, who is representing the U.S. Chamber of Commerce; and Mr. H. A. True,

Jr., the True Companies of Casper, WY; and Mrs. Lyda Nickell of the E. L. Nickell Co. of Constantine, MI, representing the National Small Business United.

We are very happy to have all of you here. It has been my privilege to have known several members of this panel in the past, worked together in a number of areas. I mentioned Mr. Goodner from my home State. Mr. True and I have worked together on a number of other projects, including trying to maintain some energy independence for this country. I am happy to have all of you.

I think the procedure that we will follow in the interest of time is that we will begin. We will just go right down the list. If each one of you can summarize your testimony as best you can, if possible, we will put your full statements into the record. And we will do our best to restrain ourselves on questions until we have heard from all four members of the panel. And then we will address our questions to the panel.

So, Mr. Goodner, we will begin with you. We are very happy that all of you are here this morning. We would welcome your testimony.

Mr. GOODNER. Thank you.

Senator BOSCHWITZ. I would say, Mr. Goodner, that I see in your testimony that your son is coming into your business. Three of my sons are already in my business, and the fourth one is graduating from college as is yours, and he wants to come into it. I have the same feelings.

Senator BOREN. The Boschwitz enterprise is now beginning to come under capable, well-considered management. [Laughter.]

Mr. GOODNER. That's what I'm trying to do.

STATEMENT OF TOM GOODNER, GOODNER'S SUPERMARKETS, DUNCAN, OK, REPRESENTING THE NATIONAL GROCERS ASSOCIATION AND THE SMALL BUSINESS LEGISLATIVE COUNCIL

Mr. GOODNER. Mr. Chairman and Members of the Committee, my name is Tom Goodner. I am the owner and operator of Goodner Supermarkets in Duncan, OK. Our company was started in 1937 by my father. In the past 52 years we have grown to four conventional supermarkets. I now plan for my son to continue and expand this business tradition when he graduates from college. That is my only motivation to stay in business.

As the owner of a family retail food business, I am pleased to be here on behalf of the Small Business Legislative Council and the National Grocers Association. I am testifying regarding the impact of the tax laws on small business, especially the serious threat to family owned businesses which has been created by Section 2036(c) of the Internal Revenue Code.

Mr. Chairman and Members of the Committee, in Oklahoma we believe in being up front with everyone. Sometimes we may agree with you, sometimes we may disagree, but we always say what we mean and we mean what we say. And I intend to follow that code in my next few minutes.

So, let me be simple and direct about Section 2036(c). The Small Business Legislative Council, the National Grocers Association and I believe this is bad law. In fact, the IRS recently confirmed that

the terms of Section 2036(c) are neither adequately defined or susceptible to general accepted interpretation. It was enacted as the result of an inferior legislative process. It reflects an incorrect balance of important economic values. It poses serious risks to family-owned businesses and our national economy and is now maintained for all the wrong reasons.

And, Senator, I want to thank you, as well as other Members of this Committee and the 26 Members of the Senate who all share that same conclusion by legislation to repeal Section 2036(c). All of you cosponsored that.

Now, there is a variety of detailed reasons why this bad law should be repealed, all of which are set out in my formal statement submitted for the record. But right now, here's some brief, just straight talk that I want to talk to you about.

First, the process. You know, in high school back in Oklahoma, my children were taught that Congress passes all its laws after full Committee hearings and careful House and Senate floor deliberation. What a difference in their textbook classes and the reality of Section 2036(c).

As you know, this provision was enacted in 1987 and amended in 1988 without a single hearing and without a word of meaningful debate. Today's hearing marks an important step to reverse this process and its product.

Why did this all happen families throughout the land have been demanding? Well, basically because our own Internal Revenue Service asserted that the 1986 tax code was abusive, that it provided loopholes and evasions for wealthy families with huge estates. Unfortunately, while the rhetoric was loud, the evidence, the documentation and the record to support these allegations was virtually nonexistent. Worse still, even the few theoretical examples of questionable tax practices which the IRS and other bureaucratic staffers could dredge up were strictly limited, but the all-encompassing remedy which they crafted in the form of Section 2036(c) is immense in its potential damage. No wonder reputable economic commentators have graphically labeled it the monster which ate estate planning.

The facts are that for this country's entire history generations of family-owned and transferred businesses have been at the heart of our national welfare. You know, for the millions of us who are family enterprises, I would think the real facts would make you in Congress help not hinder this natural process.

But that is not the message of Section 2036(c). Because of its vast reach, because of its burdensome requirements, and because of its vague and confusing mandates, this law has virtually suspended intelligent family business planning. If allowed to continue, it will force new generations of my family and thousands more into leveraged buyouts and final dissolution.

By the way, I may add parenthetically that the long-awaited, recently published, clarifying regulations from the IRS are virtually worthless, highly limited in scope and impact.

So, why not just can the whole thing, repeal it and start over? Perhaps most depressing to the all too average citizen from Oklahoma or Minnesota or the other States are the reasons why the misshapen law has been permitted to remain in force.

Basically it all comes down to dollars, to revenues. In a series of continually inflating estimates, the Department of the Treasury has promised that over seven years, Section 2036(c) can be counted on to bring in some $1.4 billion to the Government. This is up substantially from the original IRS estimates of $109 million for 3 years. I say promised with real skepticism. Never have any data or substantive rationales been produced to support these guesstimates. They just increase in convenient lockstep with the political requirements of the law's supporters.

And so, in one of those magical Capitol Hill leaps of logic, small, family-owned business, organizations such as the SBLC and the NGA suddenly find themselves on the defensive. We who did not create or increase the annual budget deficit, we who already pay more than our fair share through the tax, we are now told that repeal is possible only if some alternative methods of replacing the lost Section 2036(c) revenues can be produced.

Now, such a judgment is fundamentally flawed. At least back home where I come from, when a robber is caught with the stolen cash in his pocket, we do not prevent restitution to his victim until the thief's ill-gotten gains can be replaced by some other source of funds. Bad laws produce unjust revenues. And these dollars can in no way be used to defend the continuation of poorly conceived and implemented laws. When the core of the law is biased, unfair and unwise, any argument about revenue neutrality is secondary and irrelevant.

Senators, my description of Section 2036(c) is a simple one. Here is tax law that fails to keep its promises and promises to keep its failures. Repeal it now before it can do much more of either.

That's about what I have to say. Thank you.

[The prepared statement of Mr. Goodner follows:]

STATEMENT

OF TOM GOODNER, GOODNER'S SUPERMARKETS

ON BEHALF OF

THE SMALL BUSINESS LEGISLATIVE COUNCIL

AND

NATIONAL GROCERS ASSOCIATION

BEFORE THE SENATE SMALL BUSINESS COMMITTEE

SEPTEMBER 13, 1989

Mr. Chairman and members of the committee, my name is Tom Goodner. I am the owner and operator of Goodner's Supermarkets in Duncan, Oklahoma. Our company was started in 1937 by my father. In the past 52 years we have grown to four conventional supermarkets. I now plan for my son to continue and expand this business tradition when he graduates from college. As the owner of a family retail food business I am pleased to be here on behalf of the Small Business Legislative Council and National Grocers Association. I am testifying regarding the impact of the tax laws on small business, especially the serious threat to family owned businesses which has been created by Section 2036(c) of the Internal Revenue Code.

The Small Business Legislative Council (SBLC) is a permanent, independent coalition of nearly 100 trade and professional associations that share a common commitment to the future of small business. Our members represent the interests of over 4 million small businesses in manufacturing, retailing, distribution, professional and technical services, construction,

transportation and agriculture. Through the representation of the small business entrepreneur, SBLC member associations share the common trait of representing family owned and operated business enterprises. These have developed from one generation to the next and their owners are now looking forward to passing on the business to the next generation. (A list of the SBLC membership is attached).

The National Grocers Association represents over 2300 retail grocery and food wholesaling companies operating throughout the United States. N.G.A.'s retail members are predominately independent operators that are family owned and closely held businesses encompassing supermarkets, grocery stores and convenience stores to serve the American consumer. N.G.A.'s food wholesaler members serve as the food distributors to these retail grocers.

I. SECTION 2036(c)

Small business has long been recognized as the backbone of America's economy. According to the Small Business Administration, it has created over 64% of all new jobs between 1980 and 1986, and thus has sustained the economic growth of our country during most of this decade. Of considerable importance is the fact that a very substantial percentage of small business is family owned business. The statistics make clear that time

and again when one is speaking of small enterprise one is speaking of family enterprise. Certainly every member of this committee is well aware of this identity. Your commitment to small family business has been reflected in the sound public policy that it has fostered and the growth of small business which it has encouraged. I came to Washington, D.C. today to testify in opposition to Section 2036(c) because it is contrary to this committee's commitment to small business. It jeopardizes the future of the family owned small businessperson, whether he or she is a farmer, a retail grocer, a food wholesaler, a manufacturer, or any other small business entity.

Recently, in December of last year, I felt it necessary to initiate my estate planning process with our own counsel. But we were stopped dead in our tracks by the hazards of Section 2036(c). The reach of this legislation is broad indeed. It impedes many normal family business transactions if an individual with a child:

1. gives or sells (even for fair market value) an interest in a corporation in which the child has an interest;
2. loans money (even at a market interest rate) to a corporation in which the child has an interest;
3. is a salaried employee of a corporation in which the child has interest;
4. enters into a buy/sell agreement with the corporation or partnership containing a formula purchase price (which traditionally has been respected) if the child is also a

shareholder or partner--even though the same agreement would not give rise to any such tax if all the shareholders or partners were non-family members;

5. hires the child to work in a family business if that business contains an ESOP(employee stock ownership plan); or

6. starts a new business with his or her child.

The public policy which is established by Section 2036(c) poses a real and substantial threat to small businesses throughout the nation. It was enacted in 1987 and amended in 1988, without being subjected to a single legislative hearing. Indeed, this hearing today marks only the second time that Section 2036(c) has been subject to any hearings. In the Senate Finance Committee, earlier this year, only four witnesses, one being a Treasury representative, testified very briefly on this most fundamental public policy issue.

We strongly believe that sound public policy which directly impacts on small business and in particular family owned operations must not be enacted without any hearings or any impact analysis by small business itself. We congratulate the Senate Small Business Committee upon its willingness to conduct the most thorough public examination of this issue yet undertaken.

In fact, Section 2036(c) reflects a potential fiasco in the area of public tax policy. In retrospect, estate planners and the

national press have described it in such graphic terms as "The Monster That Ate Estate Planning" and "Inheritance Tax Is Choking Successors to Family Firms." This is not exaggerated rhetoric. Indeed I am testifying here today because of my sincere concern as the owner of a family operation similar to millions of other small businesses throughout the United States. I can assure you that Section 2036(c) threatens the very future of our family owned business. It has put estate planners into such severe handcuffs that we as family owners cannot act rationally to pass our business on to our next generations. Estate tax policy should not force small business to sell out to big publicly held or foreign corporations. If it moves in any direction, our nation's tax code should profit not penalize this country's countless family owned businesses.

As members of this committee and as public policy makers who have consistently demonstrated concern for small businesses, I ask you to fully evaluate the seriousness that Section 2036(c) poses for family owned operations. You are in a position to do far better than simply repeat the sentiments of one of your fellow senators, the Honorable John Heinz of Pennsylvania. As he put it, "The best advice I can give small businessmen this year is not to die." That is a sad commentary indeed. I urge this Senate Small Business Committee to do much more. Endorse the repeal of Section 2036(c). As public policymakers supporting small business your efforts have always centered on perpetuating small business rather than destroying it through tax policy. Continuation of that record requires immediate repeal. Certainly you should not be misled by the FALLACIES OF SECTION 2036(c).

First, the IRS advocated adoption of Section 2036(c) primarily based upon the premise that estate tax freezes were being conducted in an abusive manner. For those of us who are laymen, an estate tax freeze under Section 2036(c) would be taxed as follows: if I had a million dollar business and recapitalized and put $900,000 of it into preferred stock for myself and gave $100,000 of common stock to my son, and the resulting fruits of his labor produced a $500,000 or $2 million or any substantial increase in the value of his common stock under 2036(c) this total amount would come back into my estate perhaps ten or fifteen years down the road. This would occur even though I did little or nothing to contribute to the success of the company.

Nothing has appeared on the public record to disclose why this procedure of perpetuating family owned business and producing growth in small businesses is abusive. In fact, for those of us who own family businesses this would seem a natural extension of sound public policy to promote our national entrepreneurial spirit. The discrimination here is unique to family business; if Lee Iacoca gave publicly traded Chrysler stock to his children, he would not be caught in the trap of Section 2036(c). Perpetuation, not elimination for family business, would seem a superior objective. Forcing new generations into leveraged buyouts which are uneconomical or unsound threatens the future viability of countless family owned businesses like my own and destroys the very backbone of our national economic small business community.

A second fallacy of Section 2036(c) is that it is necessary to prevent estate undervaluations. If gifts and transactions between family members are not being properly valued when made, then it only makes sense to devote all necessary resources to IRS audits and valuations at the time of transfer. The loss in present value tax collections based upon undervaluations should be attacked at the appropriate time in the appropriate way. Needless to say, there has been no evidence put on the public record that small businesses are abusing estate tax freezes by engaging in undervaluations. The entire valuation process under our tax laws inherently involves subjective interpretation both by the taxpayer and the IRS.

The third fallacy is that an estate tax solution is needed to this gift tax problem. Under Section 2036(c) it is still necessary to review transactions for many years prior to death to see if a "disproportionate transfer" was made. Section 2036(c) is so broad that any IRS agent is likely to find such a disproportionate transfer occurred. It is totally unreasonable to compound the problem by taking the approach of Section 2036(c) and taxing the appreciation that results from the gift into the donor's estate years later.

A fourth fallacy of Section 2036(c) likewise focuses upon budget considerations. When it was adopted its initial revenue estimate to close a small loophole was set at $109 million over three years. However, as we all too often see in Washington, when

public policy is enacted without careful scrutiny and an ability for critical review, "facts" concerning dollars and cents are subject to sudden wild alterations. Through a process which relied largely upon either accident or design, the most recent Treasury official estimates for seven year budget revenue loss due to 2036(c) repeal have now reached $1.4 billion. To date, the IRS has provided no information or rationale for the original revenue estimates or for their recent miraculous growth. One feels political needs have been permitted to outweigh economic realities. Either that, or the reach of the statute itself has grown by unjustifiable leaps and bounds.

Solution. Repeal of Section 2036(c) is the only acceptable correction for the mistaken public policy passed in 1987. 26 senators, including Senators Boren, Boschwitz and 6 other members of this committee, have exhibited a strong commitment to repeal by sponsoring S. 659, S. 838 and S. 849. They are to be commended for their support of small business. Repeal must be passed this year so that the families of those businessmen unfortunate enough to die now need not suffer the unfair consequences of this infamous section.

Please make no mistake: full repeal is necessary. For months and months many of us have waited for a series of clarifying regulations by the Internal Revenue Service interpreting the more general and confusing provisions of 2036(c). It was suggested by some that issuance of such interpretations might greatly reduce the hazards of the law. Well, the wait is over. On August 31st

the IRS published its document. Unfortunately, I can assure you that in virtually every area, Section 2036(c) remains as vague, confusing and damaging to family owned businesses as before.

Indeed the first page of the notice says that the statute is incapable of being understood under ordinary principles of statutory interpretation. "The italicized terms embody the significant features and operative elements, and thus delineate the scope, of the statute. Unfortunately, they are neither adequately defined in the statute nor susceptible to generally accepted interpretation." This is so because the legislation itself is inherently flawed.

While theoretically enacted to address a very narrow and limited class of estate tax abuses, its approach is so fundamentally general and all encompassing in nature that it must practice the old certain remedy for a headache...that is decapitation. To the extent that concerns may remain with the small range of legitimate abuses which do exist, it is imperative to start over. After thorough legislative hearings, Congress should draft independent, carefully restricted laws appropriate to those problems alone. The existence of such a small range of abuse cannot and must not be permitted to function as an excuse for maintenance of massively inappropriate legal devices such as Section 2036(c). Moreover, the IRS is pursuing that abuse in the courts (and winning) without Section 2036(c).

II. SELF-EMPLOYMENT HEALTH INSURANCE TAX DEDUCTION

SBLC supports the permanent authorization of a deduction of the cost of health insurance for the self-employed. Specifically, we believe the deduction allowed should be 100 percent of the costs. As you know, until 1986, the self-employed were not permitted to deduct any of the costs of their own health insurance coverage. As a result of the Tax Reform Act of 1986, sole proprietors and partners were given the right to deduct 25 percent of the costs of their insurance coverage. Unfortunately, the "privilege" of a deduction was a temporary grant that expires at the end of this year.

Although it is not widely known, the issue also affects many shareholders of S Corporations. In 1982, Congress enacted S Corporation reforms, one of which was to require S Corporation shareholders, owning 2 percent of more of the company's shares, to be treated as if they were partners for the purposes of federal tax treatment of fringe benefits, one of which is apparently, the provision of health insurance. The impact of this reform was diluted by the fact that Congress provided a five-year transition rule, hence most S Corporation shareholders did not come within the purview of the rule until calendar year 1988. I might add, there is some difference of opinion as to whether S Corporation shareholders are even eligible for the 25 percent deduction, although we believe they are eligible for the deduction.

Surely, the archaic rationale for prohibiting the deduction is no longer valid in the modern economy. We have heard it said that to allow sole proprietors or partners to deduct such costs would encourage individuals to establish sham entities merely for this advantage. It appears to be a severe penalty to impose on the millions of legitimate sole proprietors, partners and, now, S Corporation shareholders just to guard against abuse by the hypothetical few. Perhaps a more compelling reason for enacting parity is Congress' recent interest in providing access to health care. If sole proprietors and other are not able to deduct their own coverage, the inability to do so does have a chilling effect on any initiative to provide coverage for their employees. We would urge Congress to permit sole proprietors, partners, and S Corporation shareholders to deduct fully their health insurance costs.

III. PAYROLL TAXES

Payroll taxes present two problems for the small business owner. The first is a rather obvious one; many, if not most, would tell you payroll taxes are just too high. Payroll taxes adversely affect "cashflow." As any business owner will tell you, cashflow is the lifeline of any emerging business.

The second problem associated with payroll taxes is compliance with the system of calculating, depositing and reporting payroll

taxes. The deadlines are confusing, the thresholds for determining deposit schedules are unrealistic low and the reporting requirements cumbersome.

We are heartened by the fact that some modest relief may be on the way. Reconciliation may include penalty relief for inadvertent errors, for example, missing a deposit deadline by a day or two. While welcomed, such relief begs the question. We need to resolve the fundamental problems. The first step is increasing the dollar threshold for deposit categories. Second, lock-in the deposit schedule for longer periods of time. Perhaps the deposit schedule should be established at the beginning of the tax year based on the number of workers employed at the time, and then identify a calendar of specific deposit dates.

The bottom line is an overhaul of the payroll tax systems is in order.

Members of the Small Business Legislative Council

Air Conditioning Contractors of America
Alliance of Independent Store Owners and Professionals
American Animal Hospital Association
American Association of Nurserymen
American Collectors Association, Inc.
American Consulting Engineers Council
American Council of Independent Laboratories
American Dental Trade Association
American Floorcovering Association
American Institute of Architects
American Machine Tool Distributors Association
American Road & Transportation Builders Association
American Society of Travel Agents, Inc.
American Sod Producers Association
American Subcontractors Association
American Textile Machinery Association
American Trucking Associations, Inc.
American Warehousemen's Association
Architectural Precast Association
Associated Builders & Contractors
Associated Equipment Distributors
Associated Landscape Contractors of America
Association of Physical Fitness Centers
Association of Small Business Development Centers
Association of the Wall and Ceiling Industries-International
Automotive Service Association
Bowling Proprietors Association of America
Building Service Contractors Association International
Business Advertising Council
Christian Booksellers Association
Council of Fleet Specialists
Electronics Representatives Association
Florists' Transworld Delivery Association
Helicopter Association International
Independent Bakers Association
Independent Bankers Association of America
Independent Medical Distributors Association
International Association of Refrigerated Warehouses
International Bottled Water Association
International Communications Industries Association
International Franchise Association
Latin American Manufacturers Association
Machinery Dealers National Association
Manufacturers Agents National Association
Mechanical Contractors Association of America, Inc.
Menswear Retailers of America
MMTBA-The Association for Manufacturing Technology
National Asphalt Pavement Association
National Association for the Self-Employed
National Association of Brick Distributors
National Association of Catalog Showroom Merchandisers
National Association of Chemical Distributors
National Association of Development Companies
National Association of Home Builders
National Association of Investment Companies
National Association of Manufacturing Opticians
National Association of Passenger Vessel Owners
National Association of Personnel Consultants
National Association of Plumbing-Heating-Cooling Contractors
National Association of Realtors®
National Association of Retail Druggists
National Association of Small Business Investment Companies
National Association of the Remodeling Industry
National Association of Truck Stop Operators
National Association of Women Business Owners
National Campground Owners Association
National Candy Wholesalers Association
National Chimney Sweep Guild
National Coffee Service Association
National Council for Industrial Innovation
National Electrical Contractors Association
National Fastener Distributors Association
National Grocers Association
National Independent Dairy-Foods Association
National Knitwear & Sportswear Association
National Lumber & Building Material Dealers Association
National Moving and Storage Association
National Office Products Association
National Paperbox & Packaging Association
National Parking Association
National Precast Concrete Association
National Shoe Retailers Association
National Society of Public Accountants
National Tire Dealers & Retreaders Association
National Tooling and Machining Association
National Tour Association
National Venture Capital Association
Opticians Association of America
Organization for the Protection and Advancement of Small Telephone Companies
Petroleum Marketers Association of America
Printing Industries of America, Inc.
Professional Plant Growers Association
Retail Bakers of America
SMC/Pennsylvania Small Business
Small Business Council of America, Inc.
Society of American Florists
Specialty Advertising Association International
United Bus Owners of America

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Senator BOREN. Thank you very much. I think that is clear, and I think you will find yourself quoted again probably on the Senate floor and in the Finance Committee with your robber comments because it is absolutely correct.

Mr. Hunt.

STATEMENT OF ROY H. HUNT, PRESIDENT, HUNT TRACTOR, INC., LOUISVILLE, KY, REPRESENTING THE U.S. CHAMBER OF COMMERCE

Mr. HUNT. I am Roy Hunt, president of Hunt Tractor in Louisville, KY, and a member of the U.S. Chamber of Commerce's Small Business Council and also chairman of the Kentucky Small Business Advisory Council.

I am really pleased to have the opportunity today to talk with you about Section 2036(c) estate freeze rules. And we also have grave concerns about some other facets of the tax code, the payroll tax reporting and deposit requirements, the Federal unemployment surtax, the self-employment health insurance tax deduction, and Section 89.

And it is, indeed, refreshing to learn of Congressman Rostenkowski's edict of today. It has been one of the mysteries of the simple-minded electorate, of which I am a part, that Congressman Rostenkowski was always able to win by a majority of 1 to 315.

In 1946, I purchased a one-third interest.

Senator BOREN. Many of us have been praying for his conversion on some of these points.

Mr. HUNT. I will try to keep my testimony maybe a little bit different from the things that have already been said, but some of them are going to be repetitive unavoidably.

In 1946 I purchased a one-third interest on borrowed money in the farm equipment business, a part-time business at that time with one employee. That was immediately after my release from the U.S. Navy in World War II.

The business was owned by my father and my brother, and due to our father's rapidly failing health, my brother and I purchased in 1949 my father's interest.

In 1976, my son Scott and I purchased my brother's interest. The brother had no heirs and had no particular interest or motivation in working further to expand or grow the company.

Between 1982 and 1985, we became aware of estate planning problems, family planning problems, and we initiated plans and discussions to assure an affordable procedure to develop a process of continuity so that our progeny and our loyal employees could continue to operate, have a place to work. And our sales from 1946 grew from something like $11,600 and one employee in 1946 to more than 60 employees and some $14 million in sales in 1988.

Unfortunately in late 1985, our estate planning consultant died suddenly of a massive heart attack, and in the interim following that, while we were evaluating that loss and attempting to recover some degree of plan continuity, the Tax Reform Act of 1987, including the anti-family business provision of Section 2036(c) of the Internal Revenue Code, was enacted.

Since then we have developed an alternative to the estate freeze technique that was permitted prior to 1987. However, that alternative has come at great cost and sacrifice and involves expensive insurance products. It threatens the liquidity and cash-flow balances and, unfortunately, another cycle of devastating inflation, such as we experienced during 1978 to 1981, would jeopardize our present procedure and the future of our business.

I join the chamber in supporting complete repeal of Section 2036(c). As Mr. Goodner and previous speakers reminded you, you will remember that Section 2036(c) was enacted without congressional hearings or debate. Many families who will be affected by the law are just now discovering its existence. The law calls into question the viability of many commonly used methods of transferring business assets not just the estate freeze procedure, but other methods that have been used in transferring business assets from one generation to the next and thereby jeopardizes the continuity of family ownership of many farms, ranches, and small businesses and their employees.

Defenders of Section 2036(c) argue that the law is necessary to curb tax avoidance schemes—and I do not like the word "scheme" there. I would rather use "devices" or "procedures"—devised by clever estate planners. Yet the law eliminates some of the most equitable and commonly used and legitimate methods of passing a family business from one generation to the next without incurring a tax liability so large that it forces the sale of the business outside the family. That has already been mentioned—the impact of that procedure—earlier. Those who will suffer from the law are hard-working families who have worked together and who hope to pass their business intact to future generations.

Building a family business offers a lot of rewards. Perhaps the greatest is the knowledge that a business is a result of a lifetime of hard work, that it can be passed on to one's children and grandchildren.

Unfortunately, passing on a family business intact can be a difficult task. The first $600,000, as you know, is exempt from tax. However, many family businesses and farms are worth more than this. The Federal estate tax begins at 37 percent of amounts above $600,000 and increases to 55 percent of assets above $3 million. In short, great quantities of cash can be required to pay estate taxes. If an estate does not have sufficient cash to pay the taxes or if the heirs cannot afford to buy the business, the business may have to be sold outside the family or dissolve in order to pay the taxes.

Most small businesses are not very liquid. My chief responsibility in my own business is to try to turn over a $1,000 bank account 10,000 times a week. And it requires a lot of maneuverability and a lot of thought.

Elimination of the estate freeze is a real blow to family business. Anyone who owns as little as 10 percent of the voting power or income stream from a business enterprise can be affected. What this law really means is that even if the founder gives, paying the requisite gift taxes, or sells significant portions of his business to his heirs prior to his death, those heirs may still be faced with a huge estate tax burden as long as he retains as small as 10 percent interest in the business.

The complexity and potentially far-reaching effects of Section 2036(c) are indicative of a disturbing trend. Family businesses are increasingly required to comply with confusing regulations and to pay burdensome taxes. In this case years of litigation would really be required to determine which intra-family transfers are covered by Section 2036(c) and which are not. Tax attorneys and business planners are confused by the law, and consequently, family businesses are receiving conflicting advice.

This section places an unwarranted burden on family businesses and should be repealed. Tax laws should help preserve family businesses, not encourage their sale and dissolution.

Another major obstacle of small businesses, as has been testified earlier, is the tax code involving the compliance with payroll and reporting and deposit requirements. Payroll taxes naturally impose a higher burden of compliance on smaller firms than other provisions of the tax code. In a small business, often it is the owner who actually has to determine whether a deposit is due and how much it should be. Reform of the payroll tax reporting and deposit system would be of significant benefit to small businesses and could be accomplished with little or no impact on revenue.

The present system for determining the frequency of deposits is complicated and requires that the employer continually calculate his deposit liabilities to determine when a deposit is required. An employer at different times of the year may be required to deposit monthly, quarterly or more frequently, and this can lead to confusion and missed deadlines which, in turn, can lead to unreasonable penalties.

In fact, the penalty that is the most troublesome to small business members is the payroll tax deposit penalty. Very minor infractions, often under-payments of only a few cents, can lead to a penalty of large magnitude.

Under current law, if a taxpayer fails to make a payroll tax deposit on or before a prescribed due date, a penalty will be imposed equal to 10 percent of the deposit. The same 10 percent penalty would apply if the taxpayer is only 1 day late in making a payroll tax deposit or if he is 30 days late or more. And this is true whether it is an innocent error or a dereliction of responsibility or an alleged error in many cases.

In order to provide that a taxpayer with an incentive to make a payroll tax deposit on or as close as possible to the prescribed due date, the chamber has recommended a graduated payroll deposit penalty procedure.

I would like to comment briefly on the 25 percent deduction for health insurance costs for a self-employed individual. I can be really objective about this because my business is incorporated, but this is one of the most flagrantly inequitable and unfair business taxes that exists in the code today.

Section 162 of the code provides that self-employed individuals may deduct 25 percent of the amount paid for health insurance for the individual, the individual's spouse and dependents. This provision was added in the code in 1986 to make the tax treatment of health insurance benefits of self-employed individuals fairer and to encourage broader coverage in this sector.

I would submit that at a time when we are so concerned with increasing the coverage of health insurance and to make tax codes fairer to small businesses who still elect to remain as proprietorships and partnerships, that this 25 percent deduction makes no sense whatsoever, but should be expanded to 100 percent. This is not the only remedy that is needed to increase health care coverage, but it would be an important step.

I would like to commend John Motley's testimony on the intent. Those of us in the small business sector sometimes wonder whether you are for us or against us. And I think this has been reflected by much legislation that has been enacted in the past 10 years.

I would like to close with a quote by former President Woodrow Wilson that I guess a lot of us subscribe to. And it is interesting to note that he made this during his campaign, and I just wonder he would think about it after he was President.

In 1913, he said, "The City of Washington is in some respects self-contained, and it is easy there to forget what the rest of the U.S. is thinking about." Those in the small business sector subscribe to Woodrow Wilson's quotation.

Thank you.

[The prepared statement of Mr. Hunt follows:]

Statement of the U.S. Chamber of Commerce

ON: SECTION 2036(c)-ESTATE FREEZE RULES, PAYROLL TAX REPORTING AND DEPOSIT REQUIREMENTS, FEDERAL UNEMPLOYMENT SURTAX, AND SELF-EMPLOYMENT HEALTH INSURANCE TAX DEDUCTION

TO: SENATE COMMITTEE ON SMALL BUSINESS

BY: MR. ROY HUNT

DATE: SEPTEMBER 13, 1989

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest federation of business companies and associations and is the principal spokesman for the American business community. It represents nearly 180,000 businesses and organizations, such as local/state chambers of commerce and trade/professional associations.

More than 93 percent of the Chamber's members are small business firms with fewer than 100 employees, 45 percent with fewer than 10 employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business--manufacturing, retailing, services, construction, wholesaling, and finance--numbers more than 10,000 members. Yet no one group constitutes as much as 32 percent of the total membership. Further, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the 59 American Chambers of Commerce Abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross section of its members serving on committees, subcommittees and task forces. Currently, some 1,800 business people participate in this process.

TESTIMONY
on
SECTION 2036(c)-ESTATE FREEZE RULES,
PAYROLL TAX REPORTING AND DEPOSIT REQUIREMENTS,
FEDERAL UNEMPLOYMENT SURTAX, AND
SELF-EMPLOYMENT HEALTH INSURANCE TAX DEDUCTION
before the
SENATE COMMITTEE ON SMALL BUSINESS
for the
U.S. CHAMBER OF COMMERCE
by
Mr. Roy Hunt
September 13, 1989

I am Roy Hunt, President of Hunt Tractor in Louisville, Kentucky and a member of the U.S. Chamber of Commerce's Small Business Council. I am pleased to be here today to testify before this committee on Section 2036(c) "estate freeze rules," payroll tax reporting and deposit requirements, the federal unemployment surtax, and the self-employment health insurance tax deduction.

In 1946, I purchased a 1/3 interest, on borrowed money, in a farm equipment business--a part-time business at that time with one employee.

The business was owned by my father, R.S. Hunt, and my brother Raymond Hunt. Due to our father's rapidly failing health, Raymond and I purchased his interest in 1949 and incorporated. In 1976, my son, Scott, and I purchased my brother's interest. The brother had no heirs and had no particular motivation for working to expand the company.

Between 1982-85, we initiated plans and discussions to assure an affordable procedure to develop a system of continuity so that our progeny could continue to operate and own our business, which grew from sales of $11,600 and one employee in 1946 to more than 60 employees and some $14 million in sales in 1988.

Unfortunately, in 1985 our estate-planning consultant died suddenly of a massive heart attack. While we were evaluating that loss and attempting to recover plan continuity the Tax Reform Act of 1987--including the anti-family business provision, Section 2036(c) of the Internal Revenue Code--was enacted.

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Since then, we have developed an alternate to the "estate freeze" technique permitted prior to 1987. However, that alternative has come at great cost and sacrifice and involves buying expensive insurance products. It threatens liquidity and cash flow balances; and, unfortunately, another cycle of devastating inflation, such as that experienced during 1978-1981, would jeopardize our present procedure and the future of our business.

The Chamber supports the repeal of Section 2036(c). This complex and confusing law was enacted without Congressional hearings or debate. Many families who will be affected by the law are just now discovering its existence. The law calls into question the viability of many commonly used methods of transferring business assets from one generation to the next and thereby jeopardizes the continuity of family ownership of many farms, ranches, and businesses.

Several bills have been introduced to repeal Section 2036(c). Senator Daschle has introduced S. 849, Senator Symms has introduced S. 659, and Senator Heflin has introduced S. 838. Twenty-six Senators are presently sponsoring or cosponsoring at least one of these bills. Representative Archer has introduced H.R. 60, which has 119 cosponsors in the House of Representatives. The repeal of Section 2036(c) is preferable to further attempts to amend the law. Such attempts will only increase the law's complexity and are unlikely to help family businesses significantly.

The repeal of Section 2036(c) would not result in a significant loss of revenue. When the law was enacted in 1987, it was estimated that it would raise only $109 million over three years. This amount of money does not justify the law's potential harm to family enterprise and does not support the argument that there was substantial tax avoidance in previous intrafamily transfers.

The Chamber is working extensively for the repeal of Section 2036(c). It has produced an *It's Your Business* television program examining the law and its potential impact and has published numerous articles and position papers supporting the law's repeal. The Chamber will continue to take every opportunity to voice its opposition to this law and work for its repeal.

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Defenders of Section 2036(c) argue that the law is necessary to curb tax avoidance schemes devised by clever estate planners. Yet the law eliminates some of the most commonly used and legitimate methods of passing a family business from one generation to the next without incurring an estate tax liability so large that it forces the sale of the business outside the family. Those who will suffer from the law are hard-working families who hope to pass their businesses intact to future generations.

Family-owned enterprises are the essence of the American dream. The family farm and family business are the backbone of the American economy. The family farm has made America second to none in agricultural production and productivity. The spirit of hard work and entrepreneurship necessary for success in family business results in the creation and marketing of ideas and inventions that large, established corporations would shun.

Building a family business offers many rewards. Perhaps the greatest is the knowledge that a business that is the result of a lifetime of hard work can be passed on to one's children and grandchildren. Unfortunately, passing on a family business intact can be a difficult task. The first $600,000 of an estate is exempt from tax. However, many family businesses and farms are worth far more than this. The federal estate tax begins at 37 percent of amounts above $600,000 and increases to 55 percent of assets above $3 million. In short, a good deal of cash can be required to pay estate taxes. If an estate does not have sufficient cash to pay the taxes or if the heirs cannot afford to buy the business, the business may have to be sold outside the family to pay the taxes.

One of the more common methods of ensuring that a business would not have to be sold to pay estate taxes was the use of the estate or valuation freeze. The estate freeze typically involves an aging founder recapitalizing the business. Much of the current value and voting power and/or income is allocated to preferred stock, which is retained by the founder. The founder then gives or sells common stock to his heirs. The future increase in value of the business is allocated to the common stock and generally will not revert to the founder's estate upon his death. The founder's preferred stock will not rise

in value, and at death estate taxes will be owed on only the value of that preferred stock. In this scenario, the founder's death will not trigger a huge estate tax bill.

The estate freeze is not unfair to the federal Treasury. When a firm is recapitalized, the founder is typically old, and it is the heirs who remain active in the business and make it more valuable. It is, therefore, appropriate that taxes on that increased value should be paid by the heirs when they either sell the business or die.

The estate freeze and similar intrafamily transfers are no longer a viable means of passing a family business from one generation to the next. Section 2036(c) states that any person holding a "substantial interest" (defined as 10% of the voting power or income stream) in an "enterprise" who "in effect" transfers after December 17, 1987, property having a "disproportionately large share of the potential appreciation in such person's interest in the enterprise while retaining an interest in the income of, or rights in, the enterprise," shall be deemed to have retained the enjoyment of the transferred property. This means, quite simply, that any increase in value attributable to the assets transferred to the heirs through the typical estate freeze will revert to the transferor's estate upon death. This can mean the end of a business or farm with a significant amount of nonliquid assets. As the American College of Probate Counsel has pointed out, Section 2036(c) "unfairly favors families whose wealth is represented by cash and marketable securities over those who own farms or small businesses."

Elimination of the estate freeze is a severe enough blow to a family business. Yet as the recently released Internal Revenue Service (IRS) guidelines on Section 2036(c) demonstrate, the law will affect far more than the generic estate freeze. This law calls into question the viability of a number of methods of making intrafamily asset transfers; it may adversely affect transfers pursuant to family buy-sell agreements and similar intrafamily transfers. Anyone who owns as little as 10% of the voting power or income stream from a business ("enterprise") can be affected. What this law means is that even if the founder gives (paying the requisite gift taxes) or sells significant portions of his business to his heirs prior to his death, those heirs may still be faced with a huge estate tax burden as long as he retained an ownership interest in the business.

The complexity and potentially far-reaching effects of Section 2036(c) are indicative of a disturbing trend. Family businesses are increasingly required to comply with confusing regulations and pay burdensome taxes. In this case, only years of litigation will determine which intrafamily transfers are covered by Section 2036(c) and which are not. Tax attorneys and business planners are confused by the law. Consequently, family businesses are receiving conflicting advice.

Section 2036(c) places an unwarranted burden on family businesses and should be repealed. Tax laws should help to preserve family businesses and farms, not encourage their sale and breakup.

Payroll Tax Reporting and Deposit Requirements

One of the biggest complaints that small businesses have with the Tax Code involves compliance with payroll tax reporting and deposit requirements. These are the rules that require firms to deposit Social Security taxes and income tax withholdings with an authorized bank depositary (or Federal Reserve Bank), which serves as a tax collection vehicle for the federal government.

Payroll taxes are likely to impose a higher burden of compliance on smaller firms than other provisions of the Tax Code. In a small business, often it is the owner who actually has to determine whether a deposit is due and how much it should be. Reform of the payroll tax reporting and deposit system would be of significant benefit to small businesses, and could be accomplished with little or no impact on revenue.

The present system for determining the frequency of deposits is complicated and requires that the employer continually calculate his deposit liabilities to determine when a deposit is required. An employer may at different times of the year be required to deposit quarterly, monthly, or more frequently. This can lead to confusion and missed deadlines, which in turn lead to stiff penalties.

In fact, the penalty that is the most troublesome to the small business members of the Chamber is the payroll tax deposit penalty. Very minor infractions, often under-payments of only a few cents, can lead to a penalty of large magnitude.

Under current law, if a taxpayer fails to make a payroll tax deposit on or before a prescribed due date, a penalty will be imposed equal to 10% of the deposit. The same 10% penalty would apply if the taxpayer is only a day late in making a payroll tax deposit, or if he is 30 or more days late.

In order to provide a taxpayer with an incentive to make a payroll tax deposit on or as close as possible to the prescribed due date, the Chamber has recommended a graduated payroll deposit penalty.

The House tax bill, in its present form, provides that a taxpayer is subject to a penalty of 2% of the underpayment if the failure to deposit payroll taxes is not corrected within five days, 5% if not corrected within 15 days, and 10% if not corrected after 15 days. The bill also generally provides for a 15% penalty if the tax is not paid within 10 days of when notice is given by the IRS.

The Chamber does not agree with the necessity for the 15% penalty as part of the graduated payroll deposit structure. Moreover, it also has concerns about the procedural application of the 15% penalty itself. Since notice is given by the IRS by mail, a taxpayer may actually only receive a few days' notice before assessment of the 15% penalty. Businesses that have already fully disclosed their payroll activities on their quarterly return should be provided more than a few days' actual notice before the penalty increases by 50%, from a level of 10% under current law to 15%.

Senator Pryor, Chairman of the Subcommittee on Private Retirement Plans and Oversight of the IRS of the Committee on Finance is also drafting a penalty reform bill. The Chamber has submitted comments on the payroll tax deposit penalty to Senator Pryor.

It is the view of the General Accounting Office (GAO) that no changes be made in the payroll tax deposit penalty until completion of an IRS study of the federal tax deposit procedures. The small business community cannot support such a recommendation. For most small businesses, comprehensive civil tax penalty reform could be construed as a hollow initiative without Congress's addressing the issue of the payroll deposit penalty.

If the current method used to determine the frequency of deposits is retained, the threshold amount used to determine whether deposits are to be made quarterly, monthly, or according to the "eighth-monthly" periods system should be raised. The Chamber supports such payroll deposit proposals as raising the $3,000 deposit threshold to a more practical level or tying the deposit requirement to a more predictable payroll deposit due date or to the number of employees of a firm.

Federal Unemployment Surtax

Why should employers continue to pay a tax when the explicit purpose for that tax no longer exists? A surtax of 0.2% was added in 1976 to the tax paid by employers under the Federal Unemployment Tax Act (FUTA). The purpose of this "jobs tax" was to pay off the debt then accruing in unemployment compensation (UC) trust funds. Employers agreed to participate in paying off this debt, which was related to the extended-benefits program. In return for their support, Congress assured employers that the tax was indeed temporary and would expire when the debt was paid.

The debt was fully paid in May 1987, and the tax should have expired at the end of that year. Instead, Congress extended it for three years as part of the Budget Reconciliation Act of 1987. Employers protested to no avail.

The surtax continues to be allocated between the accounts for extended benefits and for loans to states. The Department of Labor estimates that the extended benefit account will have a balance of nearly $9 billion by the end of 1990, while the loan fund will have a balance of just over $2 billion.

Congress raised the loan fund ceiling -- fivefold -- at the same time that it extended the jobs tax for another three years. An overflow of excess funds back to the states, under the provisions of the Reed Act, was thus prevented. Certain members of Congress now characterize the difference between the projected balance and the arbitrary ceiling as a $9 billion "deficit." In fact, no convincing proof exists that the full ceiling amount would be required to meet unemployment needs in the event of a recession. It is really

a different deficit that prompts Congress to maintain the jobs tax in violation of its agreement with American employers. Trust fund surpluses make the federal deficit look smaller. This is the same reason that other FUTA funds are not released to pay for administrative financing of state UC programs.

Representatives Wyden and DeFazio have introduced H.R. 2316, which that would repeal this superfluous surtax, and Senator Boschwitz has recently introduced similar legislation. They are to be commended.

The jobs tax is a clear illustration of what has created business's growing skepticism of bargains with Congress. It is time for Congress to keep faith with the very organizations that it needs to maintain a healthy economy and a reasonable standard of living. The jobs tax should be repealed now. At the very least, it should be allowed to expire in January 1991 at the end of its extension.

Twenty-five Percent Deduction for Health Insurance Costs for Self-Employed Individuals

Section 162(l) of the Internal Revenue Code provides that self-employed individuals may deduct 25% of the amount paid for health insurance for the individual, the individual's spouse, and dependents. This provision was added to the Code in 1986 to make the tax treatment of health insurance benefits of self-employed individuals fairer and to encourage broader coverage in this sector.

The Administration, testifying before the Senate Committee on Finance on March 15, 1989, expressed opposition to extending this provision, which is scheduled to expire at the end of 1989. The Administration argues that this tax deduction does not significantly address the inconsistencies in the tax treatment of health-care expenditures and will not result in significant increases in health-care coverage.

The Chamber supports permanent extension of this tax deduction for the self-employed and supports increasing the deduction to 100%. Unincorporated small business owners should have a full deduction in order to have greater parity with their competitors who are organized as corporations and thus able to take advantage of full deductibility of health insurance costs.

The Department of the Treasury maintains that this provision affects only a small segment of the population. But the Chamber believes that this is a very important segment, particularly within the context of providing access to health care.

Many of the individuals affected by this provision are self-employed small business owners. These self-employed business owners provide jobs for more than 20 million Americans. But these business owners also represent a significant portion of the uninsured population. The Employee Benefit Research Institute estimates that 22% of self-employed business owners do not have health insurance coverage.

Several factors are responsible for this gap in coverage. Last year, most employers were faced with double-digit inflation in the costs of their health plans. This latest wave has hit small businesses particularly hard. Health insurance premiums for small companies run 10-15% higher than those in large firms, because there are fewer people among whom to spread risk and the administrative costs are higher for individuals and small groups. Indeed, if this deduction is allowed to expire, those who use the deduction could be faced with increases of as much as 8.25% in the after-tax cost of their health insurance premiums.

The Department of the Treasury maintains that the value of the deduction is not enough to induce employers to provide health insurance and thus will not result in significant increases in health-care coverage, but the Department provides no statistics to support this claim. The tax preferences for health expenditures were enacted for that very reason -- to expand coverage. Today more than 136 million Americans have coverage through corporate employer-provided plans. The Chamber believes that other forms of business organization (e.g., sole proprietorships and partnerships) should have the same incentive -- 100% deductibility -- that is given to corporations to provide health insurance.

Support for extending and expanding the tax deduction for the self-employed appears to be strong in the Senate. Senator Kasten has introduced S. 1381, which would increase to 100% and make permanent the tax deduction for the health insurance costs of the self-employed. Senator Durenberger has introduced S. 494, which would increase

the deduction to 100% and extend it for five years. More than half of the members of this Committee have cosponsored one or both measures.

At a time when the nation is more aware of the growing problem of the uninsured and the skyrocketing costs of health coverage, it makes no sense to allow this important tax deduction to lapse. Indeed, from a health policy perspective, the 25% deduction not only should be retained, but also should be expanded to 100%. This is not the only remedy that is needed to increase health-care coverage, but it would be an important step.

We thank the Committee for this opportunity to testify on the estate freeze rules, payroll tax reporting and deposit requirements, the federal unemployment surtax, and the self-employment health insurance tax deduction. These issues are of great concern to the small business community, and the Chamber encourages the Senate to take action on each of them this year.

Senator BOREN. Thank you very much.

I think even some of us who have been here a while think that is still true today, and we are constantly frustrated by it. One of the sad things, as stated by Senator Wallop earlier, as a member of the Finance Committee, I keep waiting for us to debate tax policy and make tax policy along the lines that will be sensible from an economic policy point of view. And we keep waiting for that to happen, and it does not happen because what happens instead is arithmetic takes over. People come up and say, well, you have to have X dollars in order to meet this budget formula the way it works. And so, they come at the last minute with a whole laundry list of items that add up, and the arithmetic takes over. Logic is not even talked about, and whether or not this is the kind of economic policy that you want to be following, the logic of it is not talked about.

We had a meeting this week about catastrophic health insurance. It was amazing to me. The Administration came in and testified against us doing anything to change the catastrophic health insurance. And they said if you do, if you repeal the catastrophic health insurance of if you postpone it, you are going to have to come in and figure out how to raise $2.5 billion worth of taxes on somebody else. And I said how could this be, that by repealing a bill that—well, because in the first 2 or 3 years, that bill is going to raise more through the surtax and the premiums than it is going to spend.

So, under the crazy way that we do—even though in the longrun everyone thinks it is probably underfunded if you look out 15, 20 years ahead. But in the first 2 or 3 years, which is where we always operate, it is going to raise more money than it is going to spend. So, if you repeal it—and the Administration opposes repealing it because then they will have to come up with, they say, money. They can't count that $2.5 billion as deficit reductions, so they will have to come up with $2.5 billion of additional taxes someplace else.

You sit there and you think this is wonderland. Next we are going take up how many angels can dance on the head of a pin. I mean, it is absolutely totally divorced from reality, and decisions end up getting made in a way that about the only place in the world you could even talk in these terms would be within the bounds of Treasury, OMB, two or three other agencies and the Joint Tax Committee of the Congress staff which does this bean counting, but you certainly could not go out and explain that in the real world and make people understand it.

Mr. True, we are happy to have you with us today.

STATEMENT OF H.A. TRUE, JR., TRUE COMPANIES OF CASPER, CASPER, WY

Mr. TRUE. Thank you, Mr. Chairman, and thank you for allowing me to appear today. My name is H. A. True, Jr. I'm also known as Dave True. I'm a partner and a stockholder in the entities generally known as the True Companies of Casper, WY. My comments this morning will be entirely directed toward the repeal of Section 2036(c) of the Internal Revenue Code.

My father was a landman for a major oil company, and I grew up in the business wanting to become an independent oil operator. In 1954 my wife and I actually realized this dream of owning our own business when we acquired the final outstanding interest in a formerly partially owned business and formed True Drilling Co. and True Oil Co.

As our four children grew up, they were encouraged but not pressured to join the family business. By 1971, it was apparent that all four were planning on entering the business. And during the next 3 years, significant transfers were made to them. These transfers were covered by mandatory buy-sell agreements to assure that the interests would remain in family hands. All taxes due were timely paid.

Our values of these gifts and sales were challenged by the IRS. After a long, expensive and trying pair of lawsuits, the Federal District Court ruled in separate actions upholding our valuations of both.

By 1973, our children all had become actively involved in the business, devoting all of their time, talent and energies to maintaining and expanding the enterprises. Over the years we have consistently advised our employees that this was to be a continuing business which would provide them with stable and enduring employment. Unfortunately, under Section 2036(c) we can no longer give them this assurance.

If, as in our case, a large portion of the value of a business is the result of the industrious efforts of the children involved, it seems completely inequitable for the appreciation to be taxed in the parents 'estate as this section requires. Many businesses will have to be liquidated and the employees will lose their jobs. Instead of paying income taxes, they would be collecting unemployment funds.

If the subject section had been in existence since 1971, there would be no way that our sons could pay the estate tax and continue the business that they have contributed so greatly to.

While we feel that our existing buy-sell agreements are grandfathered under this section, we already have grandsons and granddaughters who express considerable interest in joining the business. Assuming the continuation of Section 2036(c), the only advice I can give to these young people would be, "forget it. No matter how hard you work, or how much you contribute, you will never be able to own a part of the business which your grandparents and your fathers have built."

Section 2036(c) was enacted into law without any public input, hearings or debate. The reason given for submitting it was to close a perceived loophole utilized to freeze the estate value of corporate stock. Unfortunately, as written and as interpreted by the rules recently issued by the IRS, it throws the baby out with the bathwater, and it forces the discontinuation of family business upon the death of a parent who at one time had a substantial interest in the business. It includes not only family corporations, but every form of family business of which I am aware.

The section is not needed since present laws, excluding it, are adequate to cover the transfer of most family enterprises. It discriminates against family businesses. It is overly broad and will be

impossible for the Internal Revenue Service to administer. It encourages unfair application and litigation. It encourages noncompliance and fraud, and it undermines our self-assessment tax system.

Not only that, but it fails to address the problem. The problem is valuation. The only thing Section 2036(c) does is move the point of valuation from the point of the sale or the gift to the children to the point of the estate of the parents. And that does not solve the problem.

I urge the Committee to support the bill to repeal Section 2036(c) and thereby restore the ability of families to pass their businesses to family heirs. This action will enable family businesses to continue creating jobs and improving the economy of this country.

Thank you.

[The prepared statement of Mr. True follows:]

Mr. Chairman and Members of the Senate Committee on Small Business. Thank you for allowing me to appear before you today.. My name is H. A. True, Jr., and I am a partner and stockholder in the entities known as the True Companies of Casper, Wyoming. My comments are directed to Section 2036(c) of the Internal Revenue Code.

My father was a landman for a major oil company, so I literally grew up in the oil business. My contacts with his many firends in the industry convinced me that I wanted to become an independent oil operator. My first job in the oil fields was in the summer of 1931, and subsequent summer jobs helped in working my way through engineering college.

Since graduation from college in 1937, I have been involved full-time in the oil and gas business. I first worked for a major oil company in the field for over 11 years. In 1948, I gambled on an opportunity to start on a road to becoming my own boss by accepting a position of manager of a small drilling company. If the company operations were successful, I was to earn an ownership interest. Fortunately, the company operations were successful; and by 1951, I held a 50 percent ownership. In 1954, my wife and I actually realized our dream of owning our own business when we acquired the outstanding partnership interests and corporate stock owned by a business associate with whom we had been operating since 1951.

My wife and I are blessed by having four children: one girl and three boys. As the children grew, they were encouraged but not pressured to join the family

business. As they began to show an interest and work in the business, small shares were transferred to them as gifts or as sales of interests. By 1971, it was apparent that all four were planning on entering the business; and during the period of 1971 through 1973, significant transfers were made to them. These transfers, covered by mandatory buy/sell agreements to assure that the interest would remain in family hands, were treated as taxable transactions. Any taxes due were timely paid. Our values of these gifts and sales were challenged by the Internal Revenue Service. The Federal District Court, in two separate actions, upheld our valuations.

Our children all became actively involved in the businesses and have devoted their time, talent and energies in maintaining and expanding the enterprises from the time they graduated from college. In 1984, our daughter made the decision to leave the businesses; and her interests were sold to the remaining family members under the established buy/sell agreements.

During the entire period of time that our children have been involved in our business, we have been organized in a manner to assure that the businesses would continue as a viable family enterprise from one generation to the next. We have consistently advised our employees that this was to be a continuing business which would provide them with stable and enduring employment. The business has suffered the ups and downs of the energy industry. But even in today's depressed economic conditions in the industry, we still employ in excess of 700 people. Unfortunately, under Section 2036(c), we can no longer give our employees such assurances.

If, as in our case, a large portion of the value of a business is the result of the industrious efforts of the children involved, it seems completely inequitable

for the appreciation to be taxed in the parents' estate as is required under Section 2036(c). Many businesses will have to be liquidated, and the employees will lose their jobs. Some businesses will end up in the hands of larger corporations which normally move at least the headquarters of a business and reduce the number of employees because of efficiency requirements. Instead of paying income taxes, these employees would be collecting unemployment funds.

Even without the prohibitive estate taxation mandated in Section 2036(c), the Wall Street Journal, in its issue of August 9, 1989, points out that only thirty percent of the family businesses--which make up ninety-eight percent of all United States businesses--survive to the second generation and only thirteen percent survive to the third generation.

If Section 2036(c) had been in existence since 1971, there would be no way our sons could pay the estate tax and continue the businesses they have contributed to so greatly. While we feel, at least for the present, that our existing buy/sell agreements are grandfathered under Section 2036(c), we already have grandsons in college and grandsons and granddaughters close to college who express considerable interest in joining our businesses. Assuming the continuation of Section 2036(c), the only advice I can give to these young people is, "Forget it. No matter how hard you work or how much you contribute, you will never be able to own even a part of the business which your grandparents and your fathers have built."

Most small, family-owned enterprises are comprised of a single asset which constitutes the major value of the business. This is especially true in the real estate, ranch and farm industries. It does not take a very large enterprise to have a fair market value of $3 million. At today's estate tax rates, a $3 million

estate is assessed in excess of $1 million in estate taxes. Additionally, fifty-five cents of each one dollar of estate value over $3 million is paid as tax. In many instances, this forces a business into a distressed sale, total or partial liquidation, or a substantial contraction of the business enterprise in order to provide funds to pay the estate taxes.

Section 2036(c) was enacted into law without any public input, hearings or debate, and the reason given for submitting Section 2036(c) was to close a perceived loophole utilized to freeze the estate value of corporate stock. Unfortunately, Section 2036(c) as written and as interpreted by the rules issued by the Internal Revenue Service throws the baby out with the bathwater and forces the discontinuance of a family business upon the death of the parent who at one time had a substantial interest in the business. It includes not only family corporations but every other form of family business of which I am aware.

Section 2036(c) is not needed since the present laws (excluding it) are adequate to cover the transfer of family enterprises in most cases. Section 2036(c) discriminates against family businesses, it is overly broad and will be impossible for the Internal Revenue Service to administer, it encourages unfair application and litigation, it encourages noncompliance and fraud and it undermines our self-assessment tax system. Section 2036(c) should be repealed.

For years I have resisted the choices of selling or going public as most similar business have done in order to keep the business in my family and assure our employees' future employment.

If Section 2036(c) remains in the law, I would tell my sons not to make the same mistake I made by not selling the business for cash or equities which can be precisely measured in an estate.

Based upon my experience with the Internal Revenue Service, I am convinced that under Section 2036(c), the only ways to establish fair market value of a business in an estate would be: (1) sell to an outsider at a distressed price; (2) accept an unrealistically high market value established by the Internal Revenue Service; (3) establish through a long, unpleasant and expensive lawsuit a value determined by the court.

I urge this Committee to support the bills to repeal Section 2036(c) and thereby restore the ability of families to pass their businesses to family heirs. Such action will enable family businesses to continue creating jobs and improving the economy of the country.

I pledge the support of our organization to work with this or any other Committee of the Senate to establish a fair, appropriate legislation in the area of gift and estate taxation on the transfer of family-held businesses.

Thank you.

Senator BOREN. Thank you very much, Mr. True, and we appreciate your taking time to be here. You have certainly given us some matters to think about.

I want to address some questions to the whole panel again in just a moment.

Ms. Nickell, we are very happy to have you today and we would welcome your testimony.

STATEMENT OF LYDA B. NICKELL, E.L. NICKELL CO., CONSTANTINE, MI, REPRESENTING NATIONAL SMALL BUSINESS UNITED, ACCOMPANIED BY SHELBY NICKELL

Ms. NICKELL. Mr. Chairman, thank you. I feel privileged to be here.

Before I start my statement, I would like to thank Senators Boren and Boschwitz and others on the Senate Small Business Committee for their ongoing support to repeal Section 89. As you have learned from the morning papers, Chairman Rostenkowski has agreed to repeal section 89 and will extend the 25 percent deductibility provision for health insurance for unincorporated entities. That I think is very important.

Mr. Rostenkowski requested a meeting, and then met with three business groups to reach this decision. Those groups were: National Small Business United, Small Business Legislative Council, and National Association of Wholesalers. We are thrilled with this Committee. To me this indicates that our system can work.

Mr. Chairman, I am Lyda Nickell and I come from a small, rural community in Michigan. My son, Shelby Nickell, who I have asked to be here with me and who will be an inheritor of the business that I have been managing for the past 27 years—we are proud to be here on behalf of small business.

And National Small Business United as well helps to keep small business informed of legislation that may impact small business. Our survival is crucial to the survival of our economy.

To give you a brief history of E. L. Nickell Co., 45 years ago, E. L. Nickell Co. was founded by my late husband, Elwood Nickell. He was a risk-taker. He was an entrepreneur. He wanted to create something that could not be taken away, something that would continue. He dreamed the American dream. E. L. Nickell Co. is a family owned and operated small business.

Small businesses in industry add stability to a community. We do not move in——

Senator BOSCHWITZ. What does the business do?

Ms. NICKELL. What does the business do? We manufacture a steel tank that is called a pressure vessel, and it is used in commercial and industrial refrigeration and in the chemical industry basically and food processing.

We have 42 employees, long-term employees.

Small business does not move into a community and use up the tax incentives that are possibly available to them and then move out. We stay and we add to the economy of the small town, the small community.

In my community we have a population of 1,700 people. And I dare say that E. L. Nickell Co. with its 42 employees and 45 years

of being in business has an impact, a positive impact, on the economy of our community.

Section 2036(c) poses a threat to the very existence of family owned businesses and the economy of the community. In 1962, upon the death of my husband, I inherited the company, and for the past 27 years with our two sons, the dream has continued and grown. After 45 years of hard work and providing stable employment, we arrive at 1989 and section 2036(c).

I say to you Section 2036(c) is not only an unsensible law, but it is unworkable. It is a dream-killer, the American dream-killer.

In 1965, as advised by our attorney, we incorporated for liability purposes and possibly some tax advantage and for the future succession of the company. Decisions were made 25 years ago to set the future course of my company. If I had known then what I am faced with today, I would have possibly sold the business. I did have a choice at that time. Now succession may not happen. Section 2036(c) could force my sons to liquidate the company to pay taxes.

Competition. Everything I read in here is how can we become more competitive in the foreign marketplace. Don't tie our hands with Section 2036(c). Don't tie my sons' hands because they are the ones that are going to be impacted by this law.

The United States of America needs that, every one of us, if we are going to keep our country going in a positive and competitive growth direction. I know that many of you have the entrepreneurial spirit and love of your country. I implore if you care a whit about the family owned business, its continuance through succession to the sons and daughters, give serious consideration to the repeal of Section 2036(c).

I feel trapped, frustrated and confused by section 2036(c). In hearing the testimonies here this morning of many, the complications of this law, how could I be expected to fully understand it and the impact that it may have on my business as it succeeds to my sons? It surely is an exit vehicle for small business, destroying the very backbone that has made this country the greatest nation on earth.

[The prepared statement of Ms. Nickell and Mr. Knight follows:]

NATIONAL SMALL BUSINESS UNITED

"Serving America's small businesses since 1937"

Statement of Michael J. Knight and Lyda B. Nickell

on behalf of National Small Business United

before the U.S. Senate Committee on Small Business

regarding Small Business Tax Policy

September 13, 1989

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Mr. Chairman and Members of the Committee,

Good morning. This statement is submitted on behalf of Lyda Nickell of Costantine, Michigan and Michael Knight of Fairfield, Connecticut. We are members of National Small Business United. NSBU has been active in the discussion of the important small business tax issues you have invited us here to discuss this morning. First, we would like to thank you for holding this hearing. Very often in the past, it has been the light that the Small Business Committee has shed on important issues that has been the catalyst for action in the rest of the Senate. It is our hope that such will be the case today.

As you may well know, National Small Business United (NSBU) is the oldest association exclusively serving the small business community of our nation--for over 50 years now. NSBU is a voluntary association of small businesses from across the country, founded from a merger of the National Small Business Association, and Small Business United. NSBU serves over 50,000 individual companies with members in each of the fifty states, as well as local, state, and regional associations.

I

Subsection 2036(c) of the Internal Revenue Code poses devastating problems for the continuation of family-owned and operated businesses in this country, and we urge its swift and complete repeal. 2036(c) does not merely represent a misdirected attempt to correct a real problem; 2036(c) represents a fumbled attempt correct "problems" more presumed than real. Even if the abuses imagined were widespread, 2036(c) represents a misguided attempt to deal with it, a scatter-gun solution to a narrow problem. We strongly urge the Senate and the entire Congress to repeal Subsection 2036(c) immediately.

First, some background. Subsection 2036(c) was designed to end estate freezes, which were seen as an attempt to circumvent the tax structure, especially gift and estate taxes. These taxes start at a rate of 37% and go as high as 60%--nearly double the maximum income tax rate. Unless the family were otherwise wealthy in liquidity, it can be clearly seen what an impediment these taxes can be to the continuation of the business--if the entire estate is transferred at once, at death.

Hence, the estate freeze has developed. A business could recapitalize and create two different sorts of stock. One sort of stock (preferred) would be retained by the original owner of the

business, and it would carry with it control of the business and 80% or 90% of the value of the business at the time of recapitalization; that value, however, would remain fixed and unable to share in the future appreciation of the business. The heirs-apparent would receive non-voting common stock, currently worth only a small percentage of the value of the business, but which would receive the benefit of all future appreciation in the value of the business. At the time of death or transfer of the voting preferred stock, only the fixed value of that stock is taxable.

It is here that some believe an abuse is taking place. Without the recapitalization, they say, the full value of the business would have been subject to the enormous estate taxes. Otherwise, the government would only receive revenue from the taxation of the original gift of common stock; if it was a sale at a proper value, there would be no generation of tax revenue at all (other than sales taxes). Essentially, then, it is argued that heirs are avoiding estate taxes on a larger amount by paying gift taxes, earlier, on a smaller amount.

There are some basic flaws in this argument. The first is the assumption that the business will appreciate in value. If it does not appreciate, some sort of tax (estate or gift) will be paid on the entire value of the business at the time of transfer. Not the Congress, the business owner, nor the IRS can predict the

appreciation or depreciation of a business. If the value of the business declines following recapitalization, after a gift tax has been paid on the higher value of the transfer, are we therefore to assume the holder of the common stock deserves a refund? It is indeed an odd sentiment for some to be bitter that individuals are paying taxes on the actual value of a gift rather than waiting to pay on what it might be worth someday. Do not all gift taxes become suspect? Is it not possible that any gift might increase in value and thereby cheat the government out of revenue?

Moreover, it is a mistake to assert that appreciation of the business and the recapitalization are unrelated. The children of a business owner may work in the business prior to controlling it. The hard work of these people is often one of the primary reasons for the appreciation of a closely-held business. The economic incentive for these children--created by recapitalization--is often the cause of this hard work. In other words, these children (adults, actually) are not reaping the rewards of some tax-exempt back-door gift from their parents so much as they are reaping the rewards of their own hard work. It is impossible for Section 2036(c) to distinguish between appreciation that is the result of the transferor's efforts and those of the transferee. To tax the family members for value they have added to the business is simply a gross injustice.

We believe that an estate freeze--in-and-of-itself--cannot properly be viewed as an abuse. There can, however, be abusive practices during a recapitalization transaction, particularly with respect to valuation. The common stock transferred could be undervalued in order to avoid paying appropriate gift taxes (or so the recipient can afford to "buy" the stock) or the preferred stock could be undervalued in order to ultimately avoid many of the estate taxes which remain. Also, there may be problems with the appropriate payment of dividends under some circumstances. The point remains, however, that Section 2036(c) is not the appropriate response to these abuses.

Quite apart from what Section 2036(c) does to the estate freeze, is what it does to all manner of intra-family business transactions. The section appears to make illegal--for families--many sorts of dealings which would be perfectly legal if conducted between complete strangers. While there is still much controversy over what exactly is covered by 2036(c) and what is not, there is little doubt that its impact is broader than simply regulating estate freeze recapitalizations. The recent guidelines (Notice 89-99) coming from the IRS have answered some questions, but not all of those questions have been answered favorably. Since the issuance of the guidelines, 2036(c) has been less devastating, but only in the sense that a neutron bomb is less devastating than an atomic bomb: it doesn't destroy everything, but the world is still unlivable for ordinary folk.

A simpler response could involve a reporting requirement for the exchange and sale of private business interests in order for those transactions to be valid. Such notification would include the source and the basis used for determining value. These would be documents which the IRS could review and immediately flag instances of potential abuse (rather than just the audit lottery). As painful as this extra paperwork would be, it would be much preferred over the nightmares of 2036(c).

NSBU believes--and we believe that it is the belief of most Americans--that it is healthy to allow family businesses to deflect some of the transfer taxes that they would otherwise be forced to pay when it comes time to pass the baton. Without such deflection, families are forced to expend huge amounts of what could be working capital to insure the continuation of their business--or sell. With all the jobs and entrepreneurial spirit created by small family-owned businesses across this country, does it make any sense to stymie those businesses after just one generation of productivity? Proper taxes should be paid, but the forced selling of a business simply makes no sense for the future well-being of the business (if it even continues to exist), its employees, or the country.

Until now, the estate freeze and other means have been recognized as legitimate ways of keeping a business in the family

and providing appropriate rewards for the hard work of sons and daughters working in their parents businesses. If abuses exist, there are ways of dealing with them without ending this long-standing tradition of family-based entrepreneurism. And this is the most offensive aspect of 2036(c). It is based upon a presumption of universal abuse and impropriety and, therefore, puts an end to family business rather than an end to the occasional abuse. 2036(c) must be repealed and quickly. If Congress still perceives areas of potential abuse, there are ways of dealing with them; this is simply not that way.

II

The next issue we were asked to address concerns extension of the 25 percent deductibility of health insurance for non-incorporated entities. We support it. In fact, NSBU supports raising the deductibility to a full 100 percent, the same enjoyed by large corporations, but realizing fiscal realities, we are advocating an increase to 50 percent.

I think the Members of the Committee will agree that it is a telling commentary on the equity of our tax law that Donald Trump can fully deduct the cost of his health care because his multi-billion dollar enterprise happens to be a corporation, yet Ma and Pa Smallbiz--working 12 hour days 6 days per week just to keep Acme

Widget Co. from going under--can only deduct 25 percent of their health care costs because they happen to be running a sole proprietorship. But the ethics of this issue aside, there is a compelling health care policy case to be made for raising this deduction.

At a time when there is so much concern and attention being paid (justifiably, we might add) to the problem of the uninsured in this country, Congress should be doing whatever is necessary to expand that coverage. Whatever figure one accepts for the number of the uninsured (31.5 million or 37 million), it remains a continuing fact that a disproportionate majority of the uninsured who are employed work for small businesses. The same firms that employ most (60%) of the uninsured workers--the ones with fewer than 25 employees--are the ones that most often operate on the margin, have the greatest rates of turnover, are most likely to go out of business, and are most likely to be unincorporated.

The case for increasing this deductibility should be quite clear. Among firms with fewer than 10 employees, corporations are more than twice as likely to provide health benefits than a sole proprietorship. In fact, a 1983 study by the Employees Benefits Research Council indicated there were more than nine million self-employed individuals without insurance--one in four of all the uninsured. It is also a fact that enabling business owners to provide insurance for themselves (a worthy goal in itself) greatly

enhances the likelihood that they will provide insurance for their employees.

This country's health care crisis is severe indeed. And small business is bearing the brunt of it. Even the Health Insurance Association of America has estimated that small employers (under 100 employees) pay 20 to 30 percent higher premiums than larger employers. The non-incorporated entities we are discussing are much smaller still, and their premiums are almost never acquired under a group plan, driving their costs up even higher than for other small employers. Given such small numbers of employees, we are better able to understand why this deduction is so important. The health care costs of the business owner represents a substantial percentage (if not all) of the health care costs of the business. A greater deduction would dramatically cut costs and provide a way to expand that coverage. A health care deduction for non-incorporated businesses not only must be continued; it must be expanded.

III

There is also a possibility that the "temporary" increase in the federal unemployment tax, first designed to end in 1987 and then extended to 1990, might not be ended on schedule after all. The current unemployment tax imposed on businesses is set at 6.2

percent of the first $7000 of each employees wage. Employers in states with no overdue federal loans are eligible for a 5.4% tax credit for unemployment contributions paid to the states, making the real FUTA tax rate 0.8 percent. Of that 0.8 percent, there is a permanent component of 0.6 percent and a temporary component of 0.2 percent, designed to fund the Unemployment Trust Fund. When this fund's ceiling was dramatically raised, the 0.2 percent surtax was extended another three years to 1990, raising another $2.8 billion.

This surtax was designed to fund expanded job placement and retraining programs, but it seems more likely that the increase was thought of as just another way of raising general revenues. The surtax should be allowed to expire as scheduled. First, it has always been an odd and counterproductive policy to help the unemployed through a tax on employment. Next, there are savings to be had through the restructuring of the system of unemployment benefits. For instance, the unemployed could be required to accept the first available job after eight weeks of a job search. Also, strikers could be prohibited from receiving benefits.

Payroll taxes, when taken together with all other taxes represent a significant burden on small business and a deterrent to new businesses and to expansions. Although a tax credit may be in order, 6.2 percent is nonetheless due and payable, possibly

hindering cash-flow. In the end, all taxes on employment ultimately hinder that employment, making all payroll taxes very inefficient manners of taxation.

IV

The frequency of FICA deposits reflects another instance of business regulations being adopted without due consideration of the unique problems of small businesses. Business owners are required to submit FICA deposits promptly after the completion of payroll. Also, a quarterly report, verifying the amount owed and the amount paid is submitted every three months.

These requirements, especially the frequency of deposits, pose special problems for small business. Often operating without significant cash reserves, small businesses are very subject to the whims of cash flow problems. Requiring such substantial payments with such frequency does not exhibit an understanding that small businesses are likely to have more money some times of the year than others. If payments were less frequent; say, once or twice per year (or even four times), small businesses could budget for such payments, saving when cash flow is good. Under a more extended plan, small business could be saved the worry of day-to-day cash flow cycles and the fear of being short just one or two hundred dollars when the tax payment is due. If the business finds

itself short occasionally, there would be less of a problem borrowing a sum once or twice per year, rather than an every-two-weeks crimp.

If there is a fear that small businesses could not properly budget for the less frequent payments, the quarterly reports could be processed more often. This report would force the business owner to take a frequent accounting of what is owed the government and remind the owner to budget accordingly. Small businesses would likely welcome a more frequent report in exchange for the ability to budget their tax payments on a more realistic and cyclical basis that reflects the full long-term productivity and profitability of the business, rather than being forced to plan employment and growth on the expectations of a given week's sales.

Once again, we would like to thank the Committee for holding these hearings and for inviting us to testify. Each of these tax issues is very important to the small business community, and we hope the Senate--and the entire Congress--will soon be ready to move forward on them in a positive way.

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Ms. NICKELL. I have a handout that I would like for you to look at, and it has to do with the estate taxes with and without Section 2036(c). And we have tried to relate this as closely as we can to our own business and where we are today. And if you will, I would like to have my son Shelby review this with you.

Senator BOREN. That will be fine.

Ms. NICKELL. Because he is the one that is going to be the most directly impacted by this if it——

Senator BOREN. Let's see. Do we have copies? Do you have copies with you?

Ms. NICKELL. I think he laid them up on the table.

STATEMENT OF SHELBY NICKELL

Mr. NICKELL. It is a very simple outline and it is much reduced from probably what true reality is. It is made simplistic so we can follow here quickly.

What you have is what would occur with our company on an installment sale today without Section 2036(c) and then with Section 2036(c). When you get down to the bottom line on a business that has a sale price today, a fair market value, of $4.6 million, without Section 2036(c) it would cost my brother and I roughly $2 million in taxes. With 2036(c), it would cost us roughly $4.3 million.

Now, if my mother left the business to you, you would have the $2.3 million to buy technology to upgrade to be more competitive than I am because as a stranger, you do not have this burden.

[Material follows:]

NATIONAL SMALL BUSINESS UNITED

"Serving America's small businesses since 1937"

Estate Taxes With and Without 2036(c)

Assumptions

- Installment sale from mother to son made in 1985 for $4,600,000
- Sale made at fair market value
- Sale was designed to insure income stream to parent
- Parent receives interest only at 10% per year
- Date of death is 1991
- Business value doubles in six years to $9,200,000
- Note payable in 15 years or longer, thereby violating qualified debt safe harbor

Without 2036(c)	With 2036(c)
sale price: $4,600,000	sale price: $4,600,000
Estate Tax in 1991	*Estate Tax in 1991*
estate tax value: $4,600,000	estate tax value: $9,200,000
unified credit: ($600,000)	unified credit: ($600,000)
taxable estate: $4,000,000	taxable estate: $8,600,000
estate tax: $2,000,000	estate tax: $4,300,000

cost of being related to seller: $2,300,000

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Senator BOREN. So, the rule applies only to intra-family transfers. It does not apply to anyone else. In other words, now, if I were not a family member, she could make the identical sort of transfers in terms of the common stock to me without tax—only related parties fall under it?

Mr. NICKELL. That is correct.

Now, gentlemen, it is just a personal feeling of mine—I wasn't going to talk this way, but I have listened to these gentlemen. I have seen the distress in them. I have seen it in my mother. What I really feel is that you are trying to legislate morality. Somehow there is something wrong with the fact that I'm her son. You as a stranger have more rights than I do. You're attacking the moral fiber of America with this type of legislation.

And I look at it and I say—now, I watch these gentlemen and I look at them and I say how much quicker are they going to possibly go to their grave because they are extremely distressed. How many people of the World War II generation that have children are sitting here really going through extreme emotional agony because they had children. They had the American dream, and now it is going to be destroyed. And they are the ones that created it.

Senator BOREN. If you have a tax consequence on the business value under your hypothetical here of $9.2 million with a hypothetical tax consequence of $4.3 million, there is no way in the world that that business would ever be able to generate the kind of cash flow that would ever enable you to be able to do that. In other words, that is an absolute—this isn't a matter of a possibility of whether you would have to dispose of the business. In fact, it is such a burden, it could kill the business altogether and a small community, let alone having it be disposed of.

Mr. NICKELL. And, gentlemen, I think if you remove the economic aspects of it, because it is so discriminatory across all races, national origins, even against handicaps if you happen to be the child of an owner, that you are going to make us mad. And when we get mad, we may get even. [Laughter.]

So, instead of passing the business on or selling it to a large corporation so I can send the check to you, what I will do is put a padlock on the door and export the jobs to Japan.

You know, you can make America mad, and when you try to legislate morality, I think you are outside the world of what government is supposed to be doing. And that is what this tax code does.

Senator BOREN. Well, this is a very dramatic example. I wouldn't say legislate morality, at least certainly not from my point of view, because it is immoral what is being done. Legislating immorality. It is such a destructive thing.

Senator BOSCHWITZ. But, of course, his mother wouldn't make the sale to a third party of the nature that would not give her any future growth. She wouldn't do it. So, I am not sure that the example is entirely appropriate.

Mr. NICKELL. I'm not sure I followed.

Senator BOSCHWITZ. You point here that the value is $9.2 million. So, you figure that by the time of your mother's demise, that the value of the company will double.

Mr. NICKELL. That is our plan. We have a strategic plan that plans that.

Senator BOSCHWITZ. But she cannot now lock in her estate tax value because of the section. But she could lock in her estate tax value if she decided to sell the business to me. I'm a stranger, a third party.

Mr. NICKELL. That's correct.

Senator BOSCHWITZ. But she wouldn't do it.

Mr. NICKELL. That's true.

Senator BOSCHWITZ. Why in the world would she do something like that?

Mr. NICKELL. Well, I can think of one reason. If you face the inevitability that we will have to liquidate the company, otherwise she might do it for the sake of the employees. So, she will seek to give to strangers before she protects her own family.

People that start businesses kind of feel about the business like it's a child. I mean, they work there more hours than they are at home. My father worked 7 days a week probably 18 hours a day for years. It was my mother and the whole family just to make it survive. It becomes a child. They want to see it go on.

Mr. HUNT. And, Senator, I would also remind you—those of us in the type of businesses in which I am engaged, we also have obligations and ethical obligations, very ethical and economic obligations, to our customers and our clientele.

Senator BOSCHWITZ. Well, you know, I am just going through the same thing. As I indicated to you, I am like Mr. True. I have four kids in the business, and we have the same consideration. And they own part of the business, always have.

Senator BOREN. I just have a couple. Let me ask. I assume Mr. Goodner has already commented about the clarifying notice on Section 2036(c) put out by the IRS. Do the rest of you share the view that he expressed that it is not helpful and it does not solve the problem?

Mr. NICKELL. I would certainly agree with that.

Mr. HUNT. I understand the new clarifications just came out a day or so ago, but I'm in possession of a 2-page letter that was written to my Congressman, Rom Mazzoli, from the expert in the Internal Revenue Service about the attributes of Section 2036(c). And it is treatise in ambiguity and contradiction. He obviously does not understand it, and I do not understand it.

Senator BOREN. Mr. True, you would agree that the clarifications from the IRS are not sufficient to handle this problem?

Mr. HUNT. I never did see any clarification from the IRS that was——

Senator BOREN. Mr. True, do you agree with that?

Mr. TRUE. I certainly do, Senator. My advisers have looked over the regulations issued by the IRS very carefully, and they inform me it does not help our situation one bit.

If I may be allowed to expand on the things Mr. Nickell has said here. In my written testimony, I point out that I am one of the few lifelong independents left in the oil business. Everybody else has gone public or sold out. And I have done that for two reasons: First, as Mrs. Nickell would do, to protect our employees; and second, to get the business to our progeny.

And, frankly, if Section 2036(c) stays on the books, I will tell my sons don't make the same mistake I did. Sell the business, get out

of all the work and worry and hassle and convert to equities that the IRS can put a value on. And then they will take part of the equities, and you will have something left. You won't have anything left if you keep on in this business.

Senator BOREN. Right.

Let me ask. We have heard what the Nickells have said and seen from this example how it is almost going to automatically force a sale and a discontinuation of the business as a family business. Would that be true in terms of the other three of you as you read this impact on your own individual business situation?

Mr. GOODNER. Senator, that is true. I first came across this because I was trying to do some estate planning, and I knew I would have to pay tax. Of course, we all know we are going to do that. Not knowing what you are going to have to pay just makes it almost prohibitive.

You know, in our business, in the retail food business particularly, it is becoming more concentrated, but we in the food business have competed quite successfully against the major chains. In fact, some of the chains have broken up, you know. And now they are coming back in and trying to buy our businesses. You know, I could sell probably and be ahead of the game. You know, you work to leave an inheritance.

You know, a small business such as ours—I'll tell you this from the grocery industry that—and I'm not against big business. Please understand that. But really, the competitive situation in the community—as you know, in Oklahoma, probably the strongest retail grocer group in the United States, and we have really all worked together and we fight hard. But there is a lot of competition. And Oklahoma probably has one of the largest margins in the food industry of any State in the Union. And I feel that big companies do not compete as aggressively as we do. Maybe we are just not as smart as they are.

But with my family, I am trying to educate my son now. I am trying to get him out of college. My wife has a couple of children that would probably like to get in the business. And you like to help them, you know. This is something that is a passion with you. It is almost more than life.

We didn't expect to be wealthy when we got in this business. I had other avenues to go, and I probably could have made more money, but my father started the business and I saw him do that. When my mother died, there was an inheritance tax at that time in 1971. It took us many years to pay that. And my father and I drew up an agreement years ago, and I started paying. And he was ill, and I ran the business. And believe it or not, I am still paying. It is just one of those things. It just takes a long time.

I expected the same thing for my son. I do not feel like my business can be held together, maybe not completely.

We are not trying to escape taxes as such. I will pay my share of taxes if I know what they are, but I can't at my age—I should have started a family sooner, but with a 20 year old son and being 54 years old, you know, you do not have a lot of time. And I cannot walk out of the business and say this is yours. I'm going to sell it all to you. I'm not going to give you any advice. I don't have anything to do with it, you know, where the business is going to go.

I am just almost passionate about independent business people in this country. I still think that is where some of the great ideas come from. I know that. Sure, we live comfortable and we want to make money. But we accomplish a lot of things too.

I know every one of my employees. I know their families. There are a lot of mandated benefits I guess, but I have been doing that for years. They are like family.

I know that I looked at the situation 4 or 5 years ago when my first wife was killed in an automobile accident, and I could have gotten out of business, put my money in 30 year Treasury bills and made more money than I am making in my business, paid the taxes and gotten completely out. But I preferred not to do that. One thing, I wanted to keep it for my family and my son.

I am very happy about it, about a lot of things. As you well know, I have spent a lot of money on education. My present wife—we've sent her daughter to school, and I have three kids in college now. Not only that, before that I put several kids through college that couldn't afford to go, some of them who worked for me and close to me. I feel like that may be the greatest inheritance you can give anyone. And it always comes back. It's great, and I like to do those things.

I just feel that independent business and passing it on is almost an American right to me.

Just give us a playing field where we know where we are is what I say. I'm not trying to escape taxes. I pay my taxes. And I do pay taxes.

Senator BOREN. Well, there is something about the strength of the country being served, at least in my opinion—I agree with what you said—by the more independent business people we have in this country, the more people in this country who have the experience of making decisions about their own affairs who are held accountable for their own decisions, as opposed to people who are in corporate bureaucracies, for example, who are not decisionmakers themselves in the sense of managing their own affairs. There is something that adds to the strength and fabric of the whole country. The more people who have the experience of bearing this ultimate responsibility themselves, the stronger our citizenship base is in this country.

And I think we lose a tremendous amount when we lose these centers of independent decisionmaking in the country. And it is a very, very unhealthy trend and the tax law should not be furthering it.

Mr. Hunt, I gather you would have the same experience of the very strong possibility the company would have to be sold if this——

Mr. HUNT. Very strong. We have attempted, as I indicated in my testimony, to provide insurance. But is a very expensive way of——

Senator BOREN. Yes. And as you have said, if an inflationary period hit where the valuation of the assets were to go sky high, it would not enable you to protect against that.

Mr. HUNT. That is another aspect that I would like to comment on briefly. Not all of our gains have been due to our expertise and management. A lot of the gains have been due to the general infla-

tion. The $600,000 exemption is worth I guess about as much as $125,000 for us 10 years ago.

Senator BOREN. Right.

Mr. HUNT. So, we have been helped in our net worth by inflation.

Personally the net worth of my company is about more than $8/10 million right now, and less than 10 percent of that is represented in any kind of what could be defined as liquid assets.

Senator BOREN. Right.

Mr. True, same problem if the company just——

Mr. TRUE. Yes. I would like to add this, Mr. Chairman. After having two experiences with the IRS valuation of parts of my business, I do not think that my business would bring on the open market enough money to satisfy the IRS claim.

Senator BOREN. But that is certainly true given the economic conditions we have been going through in the independent producer sector of the oil business.

Mr. TRUE. It certainly is. It has been a character-building time for those of us left in the business.

Senator BOREN. I think we have a balance of character on which we can coast a long time, we have built so much of it the last few years.

Mr. TRUE. Right.

Senator BOREN. I wouldn't be at all surprised if what you just said weren't the case. We have been going through this in the Agriculture Committee. Senator Boschwitz and I were the co-authors of the Farm Credit Act and the restructuring of some of the farm loans to avoid foreclosure. Now the IRS is stepping in and on the restructured loans, forgiveness of loans, they are now wanting to treat that as income and tax that, which again in some cases is more than the farms are worth on the open market, so defeating the whole purpose of restructuring and avoidance of foreclosure. We are going through the same thing.

Senator Boschwitz, any questions of the panel?

Senator BOSCHWITZ. No.

Senator BOREN. Senator Wallop?

Senator BOSCHWITZ. I'm facing the same problems they are.

Senator WALLOP. I just might say, Mr. Chairman, that before you and I worked on the reform of the estate tax laws, I had the misfortune of losing both my father and having the old tax levied against it. The principal assets of the estate were land, the family ranching business. And you know what happened to the price of land. And after probate and after the deductions and everything else, there was a period of time in about 1983 when I couldn't have sold the whole place to satisfy just the taxes levied against it.

I was struck by one thing. We have another panel, so I will defer any questions.

But each of these witnesses, without having seen each other's testimony, made very similar comments about their obligations and sense of obligations both to family and community. Mr. Hunt said it. Mr. Goodner said it. Mr. True said it, and Ms. Nickells mentioned their 42 employees. And one of the purposes of their existence in their community is loyal employees—and this is a quote I think from Mr. Hunt—can continue to have a stable place to work.

They also said building a family business offers a lot of rewards. It also entails sacrifices. One of those sacrifices is that you employ members of your family at probably less value than they could command in the corporate marketplace if they have good business skills to try to maintain and create value in the family business. And one of the incentives is the possibility that at some moment in time, they will be partners in or owners of the family business. So, the sacrifice is probably a lower standard of living for a period of time in order to shoulder——

Ms. NICKELL. For many years.

Senator WALLOP. Yes, and when it could otherwise be.

I mentioned earlier one of the things that we in our states always talk about. How do you keep the kids at home? How do you keep the kids in the State? And here we remove one of the only means that a family can provide the incentive for its children, its heirs, to remain in—providing business stability, providing employment stability and providing an honorable workplace for America.

It is a terrible mistake that was made in Section 2036(c), and it deserves to be repealed.

I will defer my questions. We have the other panel, but I thank each of you because independently you have demonstrated straight across in a variety of businesses, in a variety of regions, the consequences to this ill-founded law.

Senator BOREN. Thank you very much, Senator Wallop.

Thank all of you, members of the panel. We appreciate the comments that were made. Let us say we do understand the intensity of the feeling you have and we do understand the frustration you have, and we are going to be doing our best to try to get this stopped.

Mr. GOODNER. Let me say to you Senators that I have followed your work and I appreciate it very much, Senator Boren, Senator Boschwitz, Senator Wallop. I appreciate your positions in the past and in the future.

And again, I say all we ask is for a level playing field. We'll pay our dues.

Senator BOREN. Thank you very much.

And what we have heard today just gives us renewed commitment to seeing this through to a satisfactory conclusion. We appreciate your being here very much.

Our next panel, if they would come forward, is a panel composed of Mr. Russell Michaletz, Arthur Andersen & Company, Minneapolis, MN; Mr. Arthur S. Hoffman, Spicer and Oppenheim of New York; Mr. Thomas Reardon of Larson, Allen, Weishair and Company of Minneapolis, another Minnesotan, representing the American Institute of Certified Public Accountants; Mr. Robert Macy, Jr. of Macy & Associates of Casper, WY; Mr. Michael Knight of Michael Knight, CPA, Fairfield, CT, the latter two representing National Small Business United.

We are very pleased to have all of you here. Let's see. Is Mr. Macy here? Oh, right here. All right.

What we will do—and, of course, I apologize that we are running as long as we have this morning, but I think it is indicative of the interest that Members of the Senate have. And unfortunately, there are a number of markups going on in other committees. We

tried to computerize our membership on Committees so that we do not have Committees meeting at the same time, for Members are Members of two or three Committees. But it always happens. You need roller skates around here to get to all the Committee meetings.

But Members of the Committee will read the testimony, and we are going to talk with Chairman Bumpers to see if we cannot get some expression from this Committee on these matters.

You have heard the other testimony, and I think what might be most helpful, if you could summarize your testimony, we will receive your full statements. We will go right down the panel and perhaps hit those points that you intended to make that have not already been made by others. I think that would help us conserve time and focus our attention on some additional new information that you might bring to us.

So, Mr. Michaletz, we will begin with you, and we appreciate your being here.

STATEMENT OF RUSSELL V. MICHALETZ, ARTHUR ANDERSEN & CO., MINNEAPOLIS, MN, REPRESENTING THE MINNEAPOLIS CHAMBER OF COMMERCE

Mr. MICHALETZ. Thank you, Senator. I think it is appropriate we spend some time with the prior panel because they are the true heroes of this controversy. Most of us are just the advisers.

I want to talk about two things: First of all, the necessity for Section 2036(c), and why Section 2036(c) is bad policy and why it should be completely repealed.

Based on personal experience, I do not think that the perceived abuse of freezes is real in the practice. There were under prior law all the tools necessary for the IRS to deal with freezes. Since 1979 I have participated in six freeze transactions. Three of those have been partnerships; three, corporations.

There have been dozens of situations were freezes were considered and were not done. And you have to ask the question if a freeze is so abusive and a sure thing, why wouldn't it be used more often. And I think the reason for that is that the freeze is an economic relationship which does not necessarily save estate taxes, and it has significant side effects.

Now, you have to understand what a freeze does. In a freeze, the older generation gives up their appreciation rights, and in exchange receives back a more secure interest. And that more secure interest includes a preference as to income and liquidation.

Unless you do it on a fair market value basis, that is, the value of what is given up equals the value received back, a gift occurs. So, the preferred income interest has to have an interest rate or a return high enough to justify the appreciation rights given up. And in order to determine the interest rate used as a guide in a freeze transaction, you have to look to the marketplace for an appropriate return.

Businessowners, when you talk to them, are not always sure that their business is going to appreciate faster than this marketplace interest rate. If you think back to the early 1980s when appreciation was high and inflation was taking off, rates of interest were

also high. And so, in order to do a freeze back in those days, you would have had to have had a substantial preferred interest rate. So, it led to no action in many situations.

I guess what I am saying is that when we talk about a freeze, we are talking about a word that is a misnomer because it is not a freeze at all. What you are talking about is a transaction that increases the probability that an estate will grow because you have given them a more preferred return. But what you have done is eliminated from their estate the home run that might be hit by the company after they have done the transaction. And this would also include you've eliminated from their estate the risk of high inflation, as was reported by the other panel.

Given that the recapitalization, as I will call it instead of a freeze, does not normally ensure estate tax savings then, it is usually accomplished only when one of two situations occurs.

The first is where the security of the older generation for retirement funding is appropriate; that is, they are going to tender control or management of the company to the younger generation and it is appropriate that they have a more secure interest in the equity they have built up in prior life.

The second is to create an incentive to the younger family members so that they can remain in the business, so that they know when they are enhancing the value of the company, it is going to go ultimately in their pocketbook and not be paid in estate taxes.

Without this change in form of management at the point of time that a recapitalization is done, it is awfully hard to sell someone on doing a freeze just because the down side that they have to know they have to beat the return that is necessary to make a freeze work.

I do not think that this is really an abusive transaction. So, when Section 2036(c) was enacted, I was very surprised because I did not see the abuse in a freeze.

The second reason that I think Section 2036(c) should be repealed is that discriminates against families. The major difference between family business and other wealthy people—and I will use the word "wealthy" loosely—is that if you have $2 million or $3 million or $4 million of liquid investments, you have plenty of estate planning tools available to you because you have the ability to pay gift tax. Paying a gift tax, making a gift is the ultimate freeze because you get those assets out of your estate.

If you are in a family business with very liquidity, the ability to pay gift tax is limited. And, therefore, the freeze offered a way of ensuring the older generation that they could control the level of their estate tax for the rest of their life, maybe not eliminate it, maybe not freeze it completely, but at least the rate of increase would be controlled.

One final comment I will make is what is available if Section 2036(c) is left in existence. And I think one of the things that is available to family business was alluded to earlier, and that's a purchase of large amounts of insurance. And it is something that as a practitioner I hate to see happen because it diverts money from the business to the insurance companies.

The second thing that might be available is the transfer of business ownerships when the business first starts; that is, if you

wanted to avoid Section 2036(c), you transfer ownership to the children in the form of common stock when you first set up the company. That means transferring ownership to infants. It creates problems when those infants become the age of majority. And I have seen this in situations where some of the children are involved in the business and some are not. And you run into situations where some of the children then see their value as accessible and want to get their cash out of the company because they own common stock. The alternatives to doing a freeze for wholesale businesses just aren't good alternatives.

That's the conclusion of my comments regarding the freeze. I think more comments will be made by the other parties.

[The prepared statement of Mr. Michaletz follows:]

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September 11, 1989

Ms. Tracy Crowley
Hearing Clerk
Senate Committee on Small Business
Room 428A
Russell Senate Office Building
Washington, D.C. 20510

WRITTEN STATEMENT

RE: Senate Small Business Committee hearing on Wednesday, September 13, 1989 at 9:30 a.m. in room 428A of the Russell Senate Office Building to examine the impact of certain current tax laws on small business. The following written statement is offered on behalf of the Minneapolis Chamber of Commerce by the undersigned as its representative.

ESTATE FREEZE

ISSUE #1: Should Section 2036(c) of the Internal Revenue Code be repealed?

IRC Section 2036(c) is clearly discriminatory against family businesses, a major stabilizing force in our economy, and should be repealed.

The reason for the passage of IRC Section 2036(c), according to House reports, is to eliminate valuation problems inherent in determining the transferred value of common stock in a closely held enterprise, or the growth partnership interest in a small business. Section 2036(c) does not alleviate this problem but merely postpones it. The statute does nothing to eliminate the need for valuing the future growth interest. Additionally, the law can result in the forced sale of many family owned businesses and acts as a deterrent to younger generation participation in the family business. Finally, IRC §2036(c) raises serious questions regarding its constitutional validity.

Congress has shown that there is nothing inherently wrong with ownership of preferred stock or a preferred partnership interest by creating an exception for nonclosely-held enterprises under the Substantial Interest Test. The discrimination against closely-held enterprises is based upon the perceived difficulty in valuing these interests. IRC §2036(c) does not solve this problem but postpones and confounds it.

Estate freezes really do not "freeze" value, even in a typical "freeze" transaction under prior law. The future appreciation in a company is merely exchanged for a more certain form of current income interest. This usually occurs when a parent is nearing retirement and is planning for that event. Rather than involvement in the business they are looking for stability in retirement. Their method of doing this is to transfer the future appreciation/depreciation interest to a child in return for an interest with a more certain form of income. The parents retained asset value has not been frozen but only substituted. The income from their interest will enhance the value of their estate just as future appreciation in the company might have. Further, Section 2036(c) assumes that the transferred interest will automatically increase in value, a proposition proven wrong over and over again. Thus a "frozen" interest could result in the retention of a disproportionate portion of the business by the parents due to their enhanced income interest.

The solution to the valuation problems involved in closely held enterprises does not lie in a statute that imposes tax burdens prohibitive to the continuation of a small family business. The proper recourse to these types of problems is through the use of the existing gift tax statutes. The valuation tools necessary for the IRS are already in place under that system. Self valuation of transaction values is a cornerstone in our federal tax system. Honest taxpayers should not be prevented from entering into common, logical transactions because of the potential abusive actions of others.

Section 2036(c) is anti-family business because it impedes providing various equity incentives to younger generation family members. When a child realizes that his or her efforts are only increasing the value of their parents estate for tax purposes (increasing estate taxes up to 60¢ per dollar of value enhancement) they will be forced to either (1) look outside the family business for employment or (2) utilize expensive borrowing to completely redeem out the older generation to eliminate the Section 2036(c) impact.

In addition to the policy concerns of IRC Section 2036(c), the statute poses serious constitutional problems as well. The IRS need only demonstrate, for Section 2001 to apply, that a transaction with a family member described in Section 2036(c) has occurred. The Service need not show that a gift or transfer ever was present. Where donative intent was not present (where there was only an economic bargain) the application of §2036(c) becomes a transaction tax and not a transfer tax. A §2036(c) assessment then constitutes a direct tax on the underlying property. This unapportioned direct tax would be unconstitutional.

The Section 2036(c) tax is very broad, vague and complex. A court can find that this law is too vague to fairly enforce and thus be violative of the constitution. Supposedly, to combat this problem, the Treasury has been vested with the ability to significantly change (either contract or expand) the scope of the law, thus raising yet another constitutional issue.

Congress must recognize that the solution to "freeze" problems does not lie in the passage of a statute as potentially devastating to small businesses as Section 2036(c). A more plausible solution is to continue to bring these transactions under the coverage of the gift tax system, a system already designed to handle valuation problems. This results in a closed transaction when the varying interests are created and certainty as to the tax impact at that time.

ISSUE #2 Are there ways that Section 2036(c) could be amended to permit easier transfer of ownership to family members than under current law?

Section 2036(c) cannot be amended satisfactorily short of total repeal. The addition of further safe harbors and exceptions and the resulting need for further clarification will only create further complexity and additional traps for the unwary. Only taxpayers with the best (and most expensive) advice would dare tread the treacherous waters of §2036(c). The statute should be repealed and coverage should be transferred to the gift tax law.

The gift tax law already has the tools in place to aid in the valuation of the type of transactions encompassed by Section 2036(c). In addition to this we recommend that the gift tax law be amended to include a requirement for an independent qualified appraisal and reporting similar to the income tax charitable deduction rules pertaining to property donations. A de minimis rule would eliminate appraisals for small transactions or gifts of marketable securities.

Section 2036(c) results in continued anxiety over whether it will or will not be applied, with a final determination being made at the transferor's death. To alleviate this concern, disclosure rules should be enhanced and the gift tax statute of limitations for an estate freeze transaction should be limited to a short review period. After this period the IRS should not be allowed to question the valuation impact of the transaction. Alternatively, the gift tax statute of limitations could be extended to permit the IRS review as part of the transferor's estate tax return examination. If it is then determined that the transfer was significantly undervalued, an additional estate tax could be assessed in an amount equal to the gift tax resulting from the undervaluation.

Good faith and reasonable efforts on the part of taxpayers, along with a qualified appraisal will normally arrive at the proper valuation. The use of a qualified appraisal should shift the burden of review from the IRS to the appraisal industry. The resulting balance between IRS review needs and those of taxpayers structuring long-range plans will result in a more efficient and equitable method of dealing with an estate freeze.

If total repeal of §2036(c)is not feasible, a major adjustment which would enhance the fairness of §2036(c) would be an exception for freezes of "business interests". Individuals with substantially liquid estates (marketable stocks, bonds, etc.) do not suffer the same economic hardship at death as the family of a closely held business owner since the former have the liquidity necessary to pay estate taxes. Indeed, they have the liquidity necessary to do substantial estate planning via major lifetime gifts, even with the resulting payment of gift tax.

Closely-held business owners, on the other hand, very seldom have the liquidity to make major lifetime gifts. Thus the "freeze" offers a low cost way of limiting (but not eliminating) future appreciation in their estates. Section 2036(c) operates to eliminate the closely held business owners chance to control estate taxes similar to liquid investors. A trade or business exception to §2036(c) would be easy to define and has been frequently used in tax law historically.

ISSUE #3 Assuming the continuation of Section 2036(c), what advice can be offered to small business owners who want to leave the company to offspring?

IRS Section 2036(c) raises serious problems for the small business owner who wants to shift ownership to the next generation. The planning strategies remaining come with significant costs attached.

One solution would be to have a parent, at the initiation of an enterprise, gift a substantial portion of the enterprise to a lower generation. There is a significant potential problem with this strategy. When the child reaches adulthood they will have a right to substantial value in the family business. If a child, upon learning of their interest, demands to receive that substantial interest, family harmony could be threatened.

Possible application of Section 2036(c), whether inadvertent or deliberate, can present a small business with a serious liquidity problem. The purchase of life insurance becomes a virtual necessity, the proceeds to be used to pay any resulting Section 2036(c) tax liability. A small business with nonliquid assets is forced into further problems by the need to pay the life insurance premiums; a nonforeseen transfer of wealth from the small family business to the insurance industry.

A parent seeking to divest themselves of ownership in their company and transferring it to offspring through the use of installment notes will be counseled to do so as soon as possible to obtain the maximum benefit. This might cause the parents to transfer ownership before they are ready to retire or before the child is capable of handling the business, a potentially catastrophic situation.

IRC §2036(c) may result in the sale of family owned businesses to outside parties because of the owners inability or unwillingness to meet the complicated hurdles of Section 2036(c). Our governmental policy should not be to destroy family relationships and businesses but to foster them.

FICA REPORTING

Simplification of the deposit and reporting requirements for small businesses would be the greatest measure of relief. A monthly deposit date would reduce the amount of administrative work associated with the current deposit requirements. A monthly deposit date would also ease cash flow concerns for those employers whose cash flow does not correspond with the frequent payment dates.

PAYROLL TAXES

Based on the information provided, we are not in a position to respond to the question of whether the .2 percent surtax should be repealed. However, our experience is that payroll taxes are an irritant to small businesses. Simplification and a small business exemption from payroll taxes would alleviate the problem.

SELF-EMPLOYMENT HEALTH INSURANCE TAX DEDUCTION

A consistent tax policy should provide that self-employed individuals be allowed a tax deduction for the cost of health insurance. This deduction is already provided to employees who participate in a "Cafeteria Plan" as authorized by IRC §125 which allows employees to reduce their compensation by the cost of their insurance coverage. In addition, a shareholder-employee of a subchapter "C" corporation effectively benefits from the deduction for health insurance purchased by the corporation since the cost of this coverage is not includable in their income and is deductible by the corporation. Finally, the current 25 percent deduction is highly utilized based on our experience and should be increased to 100 percent deductibility as well as made permanent.

Very truly yours,

ARTHUR ANDERSEN & CO.

R.V. Michaletz

R. V. Michaletz

BJV

Senator BOSCHWITZ. Why don't we turn then to Mr. Macy and ask him also to comment on some of these things in the same way that Mr. Michaletz has done so that you do not read the entirety of your statement.

STATEMENT OF ROBERT MACY, JR., CPA, PARTNER, MACY & ASSOCIATES, CASPER, WY, REPRESENTING NATIONAL SMALL BUSINESS UNITED

Mr. MACY. Thank you. I'll summarize.

Senator BOSCHWITZ. Summarize and comment. The comments are really quite interesting.

Mr. MACY. My name is Bob Macy. I am a CPA. I am with the firm of Macy & Associates in Casper, WY. We are an independent firm of CPAs, thus a small business, and our client base is restricted to small businesses. Thank you for allowing me to come today.

I would like to talk just a little bit about some of the things on Section 2036(c). But for background purposes, I would like to express to you some of the things I believe to be common characteristics of a successful small business.

First of all, all successful small businesses become capital intensive. It does not matter whether they are manufacturing plants or a farm or a ranch or a retail establishment. And as they grow, the requirement for reinvested profits becomes greater and greater. And the common characteristic then is that although equity is being accumulated, it is almost always invested in nonliquid assets, that is, inventories, property, plant, and equipment, the operating assets of the business.

Now, the owners of these small businesses have the same problem. Frequently the family fortune is represented largely by their investment of the stock or equity in the small business. The family liquidity is limited because there generally simply is not a public market for a small interest in a family business.

So, under prior law, because of this lack of liquidity within the family and within the business, many small businesses did not survive the imposition of the estate tax upon the death of the principal owner. Under current law, section 2036(c), it appears as though that percentage of surviving small businesses is going to be even smaller because of the acceleration of the tax.

The specific language in Section 2036(c) is harsh, and it is very complicated, and it flat out discriminates against small business owners as they attempt to pass the business from one generation to the other.

I would like to make a small example. Let's assume for just a moment there are two families, the Smiths and the Joneses. Each family has a net worth of $1 million. The Smith family owns $250,000 of common stock and $750,000 of preferred stock in their family business. And Jones owns $250,000 of AT&T common and $750,000 of AT&T preferred. If each family wishes to transfer the $250,000 of common stock to their children, the consequences to each family are particularly and totally different.

In the case of the Smith family, the transfer of the common stock of the family business to a family member is a tainted trans-

action, and it is highly likely that the value of the common stock may come back into the Smith family estate.

In the case of the Jones family with gifting listed securities, the gift of the AT&T common stock is not a tainted transaction, and so future appreciation is excludable from their estate.

So, you have two similar transactions, but with totally different tax consequences or tax treatments under Section 2036(c).

Now, our Constitution generally provides that all citizens are to be treated equitably under the law, equitably, not necessarily fairly. But a small businessowner under Section 2036(c) is not treated in the same fashion as are similar size estates that have invested in more traditional investment vehicles.

Under the general theory of taxation, once a sale or gift has taken place, the transaction has been completed. And the tax effect of that transaction is measured and whatever taxes are due is generally paid.

However, under the current Section 2036(c), that is not the case. Although a portion of the tax may be currently due, depending upon a gift or a sale in the form of a gift tax or income tax, future estate tax may be due if the value of the small business enterprise continues to increase. At some unknown time in the future, some unknown amount of tax will be due on assets that the decedent no longer owns. This uncertainty in time and uncertainty of tax applies to those who were foolish enough to invest in their own small businesses.

Under prior law, planning for the gift or estate tax to be paid was frequently a very difficult and sometimes impossible task because, as I said, many, many small businesses are sold under the provisions of the old law. Under new law, the planning and the payment process has been made extremely difficult, if not impossible.

I do not think there is any justification to attempt to fix this particular code section, nor do I think any modifications appear to be rationally acceptable. I would urge its repeal as the only logical thing to do under the circumstances.

[The prepared statement of Mr. Macy follows:]

STATEMENT OF ROBERT MACY, JR., CPA
PARTNER - MACY & ASSOCIATES, CERTIFIED PUBLIC ACCOUNTANTS, CASPER, WYOMING
BEFORE THE SENATE COMMITTEE ON SMALL BUSINESSES
SEPTEMBER 13, 1989

Good morning. I am Robert Macy, a CPA, a partner in the firm of Macy & Associates, certified public accountants of Casper, Wyoming. We are a firm of independent CPAs and thus a small business with a client base restricted to small businesses. I am currently a member of the American Institute of Certified Public Accountants and the Wyoming Society of Certified Public Accountants. In the past I have been a member of the Council of the American Institute of CPAs and have been through the chairs in the Wyoming Society of CPAs. Currently, I am a member of the Wyoming State Board of CPAs. Today I have been invited to express my personal views on selected matters as they impact small businesses in the United States.

First of all, let me state that it is my profound conviction that small businesses and small business owners should be treated equitably under the law. I am sure that you hold that view also. However, when one views the current Section 2036(c), it appears as though that opinion may not be held by many people who are in powerful positions.

For background purposes, may I express some things I believe to be common characteristics of successful small businesses. First, all successful small businesses become capital intensive. It does not matter if it is a

manufacturing plant, a farm, a ranch, or a retail establishment. As they grow, the requirement for reinvested profit becomes greater and greater. The common characteristic is that although equity is accumulated, it is almost always invested in non-liquid assets, that is, invested in inventories, property, plant, and equipment, the integral operating assets of the small business.

The owners of these small businesses have the same problem. Frequently, the family fortune is largely represented by their investment in the stock of the small business. Family liquidity is generally very limited because there is no public market for a small interest in a family business. Under prior law, because of this lack of liquidity, many small businesses did not survive the imposition of the estate tax upon the death of the principal owner. Under current law, the percentage of surviving small businesses will be even smaller.

With that background in mind, I should like to express to you some of my views as they relate to Section 2036(c) of the Internal Revenue Code. This specific provision is designed by statutory language to apply to a typical small business enterprise. The provisions of this section are extremely harsh, very complicated, and cannot be planned for with any certainty. It flat out discriminates against those small business enterprises that attempt to survive the gift or estate tax as the business is passed from one generation to the next.

Let us assume for a moment there are two families, the Smiths and the Joneses. Each family has securities worth exactly $1,000,000. The Smith family owns $250,000 of common stock and $750,000 of preferred stock in their family business. The Jones family owns $250,000 of A T & T common stock and $750,000 of A T & T preferred stock.

Each family wishes to transfer the $250,000 of common stock to their children. It does not matter whether the transfer is by gift or sale at fair market value. The consequences to each family are totally different.

In the case of the Smith family, the transfer of the common stock of the family business to a family member is a tainted transaction. Whether gifted or sold, the future value of the common stock of the family business will come back into the Smith family estate.

In the case of the Jones family, the gift or sale of the A T & T common stock is not a tainted transaction. The future value of the gifted or sold stock is excludable from the Jones family estate.

These seem to be two similar transactions, but with totally different consequences under the current Section 2036(c) provisions.

Our constitution generally provides that all citizens are to be treated equitably under the law. Not necessarily fairly, but equitably. The owner of a small business interest under Section 2036(c) is not treated in the same

fashion as the owner of a similar sized estate that has invested in more traditional investment vehicles, for instance, listed stocks or bonds. The language of the statute clearly seems to say that the owner of a small business interest cannot, by gift or sale or a combination of both, attempt to retain their current equity and pass the rights of future appreciation on to other family members.

Under the general theory of taxation, once a sale or gift has taken place, the transaction has been completed. The tax effect of that transaction is measured and the taxes to be paid are generally currently due. However, under current Section 2036(c), that is not the case. Although a portion of the tax may be due in the form of gift tax or income tax, depending on a gift or a sale, future estate tax may be due if the value of the small business enterprise continues to increase. At some unknown time in the future, some unknown amount of tax will be due on assets no longer owned by the decedent. This makes business planning very difficult, if not impossible. This uncertainty in time and uncertainty of tax applies to those who are foolish enough to invest in their own small business. As reflected by the example of the families of Smith and Jones, current law does not afford estates of equal size similar or equitable tax treatment.

Under prior law, planning for the gift or estate tax to be paid was frequently a difficult problem for a small business owner. Under current law that planning and payment

process has been made extremely difficult, if not impossible in many cases. For those reasons, I do not believe there is any justification to attempt to "fix" this particular code section, nor do I think any modifications are rationally acceptable. Its repeal, retroactively, is the only thing that makes any sense.

The American Institute of Certified Public Accountants has developed a position paper proposing additional reporting requirements for certain corporate and partnership equity "freeze" transactions. That proposal seems to address the perceived abuses in this area. Just as small business owners have a right to equitable treatment under the law, they have an obligation to conduct themselves as responsible citizens. I would urge your favorable consideration of that proposal.

Senator WALLOP. Mr. Chairman, I have an appointment now that I must attend. Let me just, once again, offer you and Senator Boren my thanks.

I think the case has been made, and I think it will be further taped down. I doubt that any of these witnesses here are about to support the continued existence of Section 2036(c).

Mr. HOFFMAN. I assure you I won't, Senator.

Senator WALLOP. But I just wanted to thank you all, Mr. Macy especially for his trip from Casper, WY, to be here today, to let us know those views. Thank you.

Senator BOSCHWITZ. Thank you, Senator. We will now turn to Mr. Hoffman.

STATEMENT OF ARTHUR S. HOFFMAN, SPICER AND OPPENHEIM, NEW YORK, NY, REPRESENTING THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. HOFFMAN. Mr. Chairman, I am Arthur S. Hoffman, chairman of the executive committee of the tax division of the American Institute of CPAs.

Let me make two preliminary observations, and then I will skip through my remarks.

Going back to the previous witnesses, the Nickell's schedule was one which you questioned as to the end result.

Senator BOSCHWITZ. Yes.

Mr. HOFFMAN. It was shown that if they sold at $4 million, they would pay approximately $2 million in estate tax, and that if they held on, Ms. Nickell they would have a taxable estate of $8.6 million, given a compounded growth rate within the company of 12 percent, and they would have to pay an estate tax of $4.3 million. You asked why would they sell? Why would they sell at $4 million if in fact the business goes on to grow to an estate of $8.6 million?

Senator BOSCHWITZ. Why would they sell to a third person.

Mr. HOFFMAN. That's right. The reason they would sell is they couldn't run their business after Ms. Nickell's death. The objective of holding it until the death of the founder is that the business will be run by the children. But, if the children face this hypothetical $8.6 million valuation by the Internal Revenue Service and would have to pay an estate tax of $4.3 million, I guarantee the company could not afford to get the money to pay the tax. So, at that point, they would dispose of the business. It would be a foregone conclusion.

Senator BOSCHWITZ. But the point that he was making was that he could now sell to a third party in such a manner as to freeze his—that Section 2036(c) only applied and was discriminatory.

Mr. HOFFMAN. Well, if they sold at $4 million they would pay a capital gains tax, and then they would invest the remaining funds. They would have the ability to make gifts of those funds because they then are liquid. But if they held onto the business and the death occurred when it was worth $8.6 million, it would not be liquid. There would not be an ability to provide estate tax, and they could not, in the interim, be giving it away because they could not provide the gift tax.

Senator BOSCHWITZ. And, as I think Mr. Macy points out, that if the owner gives away, as I have considered giving away parts of our business to our kids, that we may not avoid the problem anyway because of Section 2036(c).

Mr. HOFFMAN. Well, the gift itself, Senator, is where you can abandon your economic interest and not be subject to Section 2036(c). But some people cannot abandon their economic interest. Some people may have to rely upon the dividends and rely upon the salary and so forth. So, it isn't easy just to give it away.

Senator BOSCHWITZ. A big salary right here. I tell you. [Laughter.]

Mr. HOFFMAN. One other observation about a previous witness' remarks. Mr. Hunt remarked that he has a problem with the estate tax, and he is taking care of it by providing for insurance. And his concern was that as the value of the business grows, the insurance is liable to be outstripped by the inflationary factors.

Well, there is another factor involved. Periodically bills come down which suggest that all insurance, regardless of incidents of ownership, be thrown back into the estate, which means that you would have to cover not only the estate taxes that you are trying to insure against, but you also would have to cover the estate taxes on the insurance, which creates an impossible burden.

There are other bills that come down periodically, such as capital gains at death. Senator Boschwitz, you remarked about capital gains at death before. And carryover basis, in fact, was put into the law. And it ultimately wound up being put into a moratorium and then repealed because it was found to be impractical.

But these bills are coming down all the time. And if they were passed without hearings and without floor debate, as Section 2036(c), we are liable to be back here a year later discussing whether or not such provisions should be repealed or put into moratorium. There are a whole host of potential threats to small business that are not yet in the law, but are always on the shelf listed under revenue option proposals.

I will go through just a few of my remarks that I prepared to speak on today.

Senator BOSCHWITZ. You know, I asked my staff—I do not know if it has been done—that maybe we should go after the estate tax in general. As I recall, it used to only bring in about $6 billion a year, though I have not looked at it for a few years. By now it must be a larger number.

Mr. HOFFMAN. Well, Senator, we do not argue about whether or not it should be 55 or 45 or whatever percent. But the fact is, just on an economic basis, as has been indicated to you here today, the 60 percent factor precludes family succession. The tax is 55 persent 55 at $3 million, plus 5 percent for the State, or if you go over a certain level within the progression, you are going to wind up being taxed to recoup your original exemptions in lower brackets. So, it does wind up at 60 percent.

The simple fact is that the tax will impact upon small business whether you freeze it or you don't because that frozen value is going to be subject to tax, assuming a freeze is allowed, and the estate tax simply is very high. Farms and small businesses having real estate can value the real estate under special use methods.

Maybe you want to consider a special use valuation method for small business or a special exemption from the estate tax. But that is beyond the scope of these hearings I'm sure.

Let me analogize the problem of Section 2036(c), compared with the estate tax high levels to something else that has arisen in Congress recently.

There have been hearings before both houses of Congress on the possible detrimental effects of leveraged buyouts, LBOs. It is alleged that they cause consolidation of businesses, reduction of competition, the decline of employment opportunities, and the wholesale increase of corporate debt.

Now, assuming that is true, isn't it a shock to realize that Section 2036(c) by eliminating freeze transactions, imposes an LBO upon the family of the deceased founder? The Government is a seller of its 60 percent interest in the business, and the family is the buyer. They must pay off a debt equal to 60 percent of the company's IRS determined values, and they must commit to running the company for years so that its income will provide the cash to retire the debt and pay the high rate of interest on deferrals. It is almost a direct analogy.

In my prepared remarks I make an observation about the overall area. I say that advisors consider the high rates of estate tax, and the generation skipping transfer tax. If the businessowner has a worldbeater in your grandchildren's generation and wishes to pass the buseness down to him, instead of to his children. There is a doubling up of the tax.

Consequently, considering the estate tax levels, including generation skipping, considering that deferral of tax, which is allowed to most small businesses fitting into estates, carries a higher rate of interest—under the current state of the tax law knowledgeable advisers often are obliged to recommend "sell now" to founders of successful businesses. It is among our least favorite messages to deliver, and it can be characterized as the wake-up call for the American dream to which Mrs. Nickell referred.

Now, Section 2036(c) has a certain momentum to it. It was imposed in 1987. It was addressed in the 1988 act, but the 1988 act addressed only focused on the technical issues. And you have raised the question, whether or not the IRS Notice, 89–99, the notice that was released a few weeks ago, relieves the basic problems. By the way, it is not proposed regulations. It is merely the interpretations of the Internal Revenue Service in notice form pending proposed regulations. In its brevity, it is 70 pages long! But it only addresses the technical issues. It does not deal with the problem that was discussed here today, the fact that the classic freeze is out, and that small businesses are drastically affected.

So, at this time we see that Congress has several choices. Congress can do nothing. They could let Section 2036(c) remain as is. And we view the consequences of inaction to be very serious and very unfortunate.

The second is that they could repeal Section 2036(c). There are allegations, however, that valuations in some freezes were questionable, but they escaped examination because the transactions were under-reported. The exchange of stock of common for preferred became a wash, which act was not a taxable event and

therefore was not reported. So, mere repeal is not responsive to the possibility that those allegations of misuse of valuations are well-founded.

The third is you can adopt an immediate cure. Proposals are being circulated to Congress and the staff to cure Section 2036(c). And we are in fundamental disagreement with proposals that would permit a freeze if the founder takes back a form of stock which imposes upon the company a dividend cost which few companies, public or private, can possibly sustain. Those dividends that would be paid on the stock are nondeductible. Therefore, the company must earn half again as much as the rate which would be imposed.

Senator BOREN. Give me an example of how that would work.

Senator BOSCHWITZ. They are nondeductible.

Mr. HOFFMAN. The dividends would be nondeductible. So, suppose you say that we are going to give you a safe harbor, a stock which pays the Federal rate of interest. Let's say it is 10 percent. The company, in order to pay a dividend of 10 percent, has to earn 15 percent because the dividend is nondeductible. The 15 percent is going to be taxed and 5 percent is going to be taken away. Ten percent will be left. There is your dividend.

Now, if you figure how a company is going to count on generating over a period of years 15 percent on 60 percent of its worth, as worth is determined by the Internal Revenue Service, you would see it is an impractical solution.

Senator BOREN. You are saying that what they are suggesting is we won't count the appreciated value of the common stock in this kind of situation if the dividend is paid——

Mr. HOFFMAN. The safe harbor. That is correct.

But, the question of what is the valuation at the time of entering into this transaction would be at issue, and the IRS would be involved in deciding what is a fair exchange at that point in time.

The fourth possibility is adopt a moratorium on Section 2036(c). During the moratorium provide that freeze transactions must be reported, and the valuations of the interest involved must be supported by appraisals. In addition, I suggest that you would hold hearings and have the Committee staff work with professional and business organizations to find practical solutions to the problems which caused the over-reaction in the form of Section 2036(c) in the first place.

The AICPA, which is an organization of 286,000 CPAs, favors adoption of a moratorium on the application of Section 2036(c) because basically we are sympathetic to the problem that the IRS was not put on notice when a freeze transaction did take place. So, you could remedy this during the moratorium. It would be quick and easy for Congress to prescribe the form of the reporting of these transactions and qualified appraisals. You have done so in the case of charitable contributions of property. And the moratorium would afford the time to conduct a study of the consequences of Section 2036(c), much of which you have heard today, and any alternative proposals.

I am sure we could find a practical way to address the problem, and I believe that the practical way is basically reporting. The issue is valuation and that was the issue addressed by Section

2036(c) in the first place except, as I said before, it was an overreaction.

Just one final point. We are addressing a law that is in place. I mentioned at the start of my remarks that all kinds of proposals come down, some of which could be picked up in the final minutes of the legislative process because they raise some money. There are proposals to lower exemptions. There are proposals to raise the transfer tax rates. There are proposals to include life insurance in gross estates, as I mentioned before, without incidents of ownership. There is a proposal to reduce the permitted redemption of stock from a corporation to pay the estate tax, and there are proposals that tax capital gains at death. Put it all together and you will not have small business going down from founder to the second generation.

Thank you very much.

[The prepared statement of Mr. Hoffman follows:]

TAX DIVISION

OF THE

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Testimony By

Arthur S. Hoffman

on

Section 2036(c)

BEFORE THE

COMMITTEE ON SMALL BUSINESS

UNITED STATES SENATE

September 13, 1989

AICPA

1455 Pennsylvania Avenue, N.W.

Washington, D.C. 20004

(202) 737-6600

Mr. Chairman, I am Arthur S. Hoffman, Chairman of the Executive Committee of the Tax Division of the American Institute of Certified Public Accountants. With me is Thomas E. Reardon, Chairman of our subcommittee on Small Business Taxation. The AICPA is the national organization representing over 280,000 CPAs.

We thank you for the opportunity to address the committee, for you are holding a hearing on matters of intense interest for our membership.

We wish to address one matter in particular, which we believe strikes at the heart of your Committee's abiding concern: Section 2036(c), the so-called "anti-freeze" provision, which impacts severely upon small businesses.

We proceed on the assumption that we, and you, and the American Public share the view that the founding and perpetuation of family-owned businesses and farms is in the national interest in several ways:

- They are a major segment of the American economy;
- They provide healthy price and inventive competition for the giant domestic and foreign concerns;
- They deliver goods and services to local communities not served by national firms;

- They employ millions in cities and towns throughout this country.

Family-owned businesses and farms are at the essence of the American Dream: to found a business in the garage, basement, or barn; employ friends and neighbors; achieve financial independence; and then live to see one's children carry-on the tradition.

It is regrettable to say that the Dream is being converted to a myth. A confluence of tax provisions leads to this result: the estate and gift tax rates (which reach 55 percent at 3,000,000, plus another 5 percent in many states); the generate skipping transfer tax; and high interest rates on tax deferrals.

Transfer taxes have not been a "hot topic" in recent years in part because of the unlimited marital deduction, which tends to postpone taxation until the death of the survivor. We expect that agitation will grow geometrically as the harsh reality of the tax-of up to 60 percent on the value of the business interest upon the surviving spouse's estate-causes abandonment of plans for family succession.

The facts is that the estate tax often is confiscatory in its application to the successful family-owned business. Payments may be deferred, but the estate tax liability bears interest; and the interest on 60 percent of the value of the business can consume its

income for years. The family loses any incentive to retain the business. Most family-owned businesses, successful or not, in the normal course of business carry as much debt as possible for working capital and capital improvements. They cannot pledge to pay 60 percent of their "fair market value," based upon a theoretical selling price determined by the Internal Revenue Service. Please understand that it does not take a great amount of income for a business to be valued, under standard methods, at levels high enough to fall into the highest estate tax brackets.

Ironically both Houses of Congress recently held hearings on the possible detrimental effect of leveraged buyouts ("LBO's") on the American economy. It was alleged that they cause consolidation of businesses, reduction of competition, decline of employment opportunities, and the wholesale increase of debt. Assuming that is true, is it not a shock to realize that Section 2036(c)-by eliminating freeze transactions-imposes an LBO upon the family of the deceased founder. The government is the seller of its 60 percent interest, and the family is the buyer. They must pay-off a debt equal to 60 percent of the company's IRS-determined value. They must commit to running the company for years so that its income will provide the cash to retire the debt and pay the high rate of interest on deferrals.

And now Section 2036(c) precludes a freeze of the value of the founder's interest at the time he wishes to pass the operations and the rewards of managing a business to members of his family, and before the company appreciates under their management. He could make

a gift of his shares, but the gift tax is as high as the estate tax, and cash in the necessary amounts ordinarily is not available to the prospective donor. Furthermore, he may need dividend income from the company.

Consequently, under the current state of the tax law knowledgeable advisers often are obliged to recommend "sell now" to founders of successful business.

The obvious result will be to accelerate the consolidation of businesses throughout the United States. Economists can project the effects upon competition, community services, and employment. We sincerely recommend that they be consulted by Congress to determine the long-term consequences of the transfer tax law, now that it includes Section 2036(c). We believe that the American Public and its Congressional representatives will consider those consequences to be unacceptable.

Section 2036(c) has developed a momentum which is not fair to those affected--including the millions of employees who rely for a living on family-owned businesses. It was adopted without hearings or floor debate. The 1988 Act (TAMRA) responded only to technical problems; and now the recently issued IRS Notice 89-99 has done the same. Corrections to comply with the law must be made by December 31, 1989, in 3 1/2 months. We appeal to Congress to consider the larger issue which we have described here today.

At this time, Congress has several choices:

1. Do nothing.

   Let Section 2036(c) remain as it is. We view the consequences of inaction to be serious and unfortunate.

2. Repeal Section 2036(c).

   There are allegations that valuations in some freezes were questionable, but escaped examination because the transactions were unreported. Mere repeal is not responsive to the possibility that the allegations may be well-founded.

3. Adopt an immediate "cure".

   Proposals are being circulated to Congress and staff to "cure" Section 2036(c). We are in fundamental disagreement with proposals which would permit a freeze if the founder takes back a form of stock which imposes upon the company a dividend cost which few companies, private or public, can possibly sustain. Furthermore, dividends are non-deductible, so a company must have pre-tax earnings to approximately 50 percent more than the dividend rate to be able to pay the obligatory dividend. Public companies pay-out the rate they can afford under the pressure of their investor-shareholders. Few use stock with a fixed dividend rate as their principal

source of capital for that reason. Proposals of this type simply are not practical solutions to the problem Section 2036(c) poses to family businesses. They provide "safe harbors" which no one would wish to navigate.

4. Adopt a moratorium.

During the moratorium provide that freeze transactions must be reported, and the valuations of the interests involved must be supported by appraisals. In addition, hold hearings, and have the committee staff work with professional and business organizations to find practical solutions to the problems which caused the initial over-reaction in the form of Section 2036(c).

We favor adoption of a moratorium on the application of Section 2036(c).

We are sympathetic to the problem that the IRS was not put on notice when a freeze transaction took place. Remedy this during the moratorium. It would be quick and easy for Congress to prescribe the form of reporting and qualified appraisals. You have done so in the case of charitable contribution of property. And the moratorium would afford the time to conduct an indispensable study of the consequences of Section 2036(c) and any alternative proposals. We can find a practical way to address the perceived problem.

One final point on this topic:

Bills periodically are introduced which, if adopted, would make retention of successful family businesses virtually impossible. These include proposals to, among other things:

- Reduce exemptions;
- Increase transfer tax rates;
- Include life insurance in the insured's gross estate regardless of ownership;
- Reduce the permitted redemption of stock to pay estate taxes; and
- Tax gains at death.

The AICPA appeals to Congress to consider the consequences of adopting such proposals upon family-owned businesses.

Senator BOREN. Thank you very much.

Senator BOSCHWITZ. Mr. Reardon is next. Mr. Reardon is from a large, independent accounting firm in Minneapolis. You are out at County 18—at 169 now?

STATEMENT OF THOMAS E. REARDON, LARSON, ALLEN, WEISHAIR & CO., MINNEAPOLIS, MN, REPRESENTING THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. REARDON. I am downtown. We have two offices in Minneapolis, and I am in the downtown area.

I would like to make a brief couple of comments. I am Thomas Reardon, and I am the chairperson of the Small Business Taxation Committee also of the AICPA.

I think a couple of the issues that we were addressing, the 25 percent health insurance deduction and the coverage of the payroll deposits—I would like to just expand a couple of items that we think could be addressed.

First, in the health insurance deduction, I think that I have heard and we agree with the expansion of it. We agree with the increasing from 25 percent to 100 percent, but I have not heard anybody discuss is this something that should be part of the permanent law or is it to be something that we are just sunsetting against so that we have to review this 3 years from now and be in the same position. I guess we would recommend strongly that it would be part of the permanent code so that it is equity, treating all people alike.

I think another area that has not been addressed that we would like to see considered is that the shareholders of S corporations are presently not even entitled to the 25 percent deduction because they are not considered self-employed. We believe because under the law they are taxed the same as a partner or the self-employed person, that the coverage should be expanded to cover these people also. We just think there is an inequity there with the S shareholder, and they should be covered by the same provisions as the other self-employed people.

Senator BOSCHWITZ. You mean that a subchapter S shareholder——

Mr. REARDON. Employee.

Senator BOSCHWITZ [continuing]. Who is active in the business—you can't deduct his insurance premium?

Mr. REARDON. That is the interpretation, yes, Senator.

Senator BOSCHWITZ. You mean the company cannot?

Mr. REARDON. No. The company has a modification. They have to add this back to the income which then is distributed to the other shareholders based on their percentage ownership.

Senator BOSCHWITZ. So, the company in determining its own taxes is not allowed to deduct the cost of the insurance of a partner in a subchapter S corporation if that partner is an employee?

Mr. REARDON. Right. And I think the ownership is down to 2 percent, if I am not mistaken. So, any employee-shareholder of 2 percent or more does not get the benefit of the medical deduction at the corporate level and at the same time does not get the deduction on the individual level.

Senator BOSCHWITZ. And is it counted as income to him in addition?

Mr. REARDON. Yes. It is added to the income of the corporation which then passes through to the shareholder. So, in essence, they are paying income on that amount. They are paying income tax on it.

Senator BOSCHWITZ. The shareholders.

Mr. REARDON. The shareholders.

In the area of deposits of payroll taxes, I guess we really support the bill that you proposed, that if we could increase that to $10,000, it does cure a lot of our problems. But I think there are a couple, three other issues in the payroll deposit area that should be looked at, and I think that we have four basic rules for making deposits. We have a $500 rule at the end of the year or at the end of the period. We have the rules from $500 to $3,000. I hope that those are being considered also because I think this is where some of the problems come, mainly with the small businesses, that I would like to see the tier increase all the way up.

And in addition, we probably should consider expanding the amount of deposit that may be made with the 941 at a quarter's end. Presently if you have $500 of tax—not more than $500 of tax at the quarter end, this can be paid directly with the form and does not have to be deposited. So, I think that if we could increase some of these numbers, we may get ourselves out of some of the penalty problems that now face small business.

I think the consensus would probably be that the variable dates that are triggered by the amount of withholding one makes is where the problem lies. And I think if we cannot get these thresholds increased, an alternative may be to just have small businesses, which would obviously have to be defined, but allow them to make deposits, say, twice a month, the 5th and the 20th, and leave it at that. Just have it so there is a consistent problem because I think it is proven that the majority of the problems that IRS and the employer has is dealing with the deposit dates and the flexibility of those dates that they miss and the penalty is severe.

And I think somehow Internal Revenue needs to be able to react to these a little bit better because we see constantly where there has been an Internal Revenue error in posting a deposit that carries on for two or three quarters. The fact that they make a mistake in the first quarter, you can't get it corrected, and then you have the same mistake in the second quarter. So, it is probably one of the most frustrating parts of the law that deals with small business and deals with their tax advisers.

I think that would be the two comments I would like to add to our list. Thank you.

[The prepared statement of Mr. Reardon follows:]

Statement of the

Federal Taxation Division

of the

American Institute of Certified Public Accountants

Before the Committee on Small Business

of the United States Senate

Hearing on

Small Business Taxation Issues

September 13, 1989

American Institute of Certified Public Accountants
1455 Pennsylvania Avenue, NW
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Introduction

The American Institute of Certified Public Accountants ("AICPA") appreciates this opportunity to offer its comments on the impact of current law regarding several small business taxation issues. The AICPA is the national, professional organization of CPAs, with over 286,000 members. Many of our members are tax practitioners who work with millions of American taxpayers: individual and business. We are deeply concerned with the impact of current law upon businesses of all sizes, in all sectors of the economy.

In particular, small businesses are encountering many problems with current laws regarding estate freezes, payroll tax deposits, estimated tax payments, the alternative minimum tax, uniform capitalization of inventory and the expiration of the self employed health insurance deduction. Due to their limited resources, small businesses have a difficult time keeping up with the multitude of changes to the tax law as the changes are enacted by Congress. Often it is only after the legislation is in effect that the adverse impact of the legislation becomes apparent to small business.

We know that Congress, Treasury, and the IRS are all concerned about the welfare of small business. However, we suggest that the economic impact on small business, and the compliance burden for small business should be considered earlier in the legislative and regulatory processes. If small business owners and their tax advisors were consulted even while legislation was being developed and before it was introduced, we believe many problems could be avoided.

At this time we offer the following recommendations on specific small business tax issues.

Section 2036(c)

Section 2036(c) should be repealed or deferred until such time as Congress has had an opportunity to examine the underlying issue, which is the impact of transfer taxes on small businesses. Without freezes, a 55 or 60 percent transfer tax will make it highly unlikely that a family business or family farm can remain in the family. Typically, a small business would not have sufficient cash to pay such a tax, nor would it be in a position to assume additional debt equal to 60 percent of its value. Such debt build-up would be the equivalent of a government mandated small business LBO.

Estate freezes have been allowed for many years. The result has been that the transfer tax on a portion of the value accumulation has been transferred to the second generation.

The estate freeze should not be eliminated until a policy decision has been reached as to whether or not family farms and businesses should be allowed to remain within the family.

The estate freeze can play a very important role quite apart from the transfer tax issue. The transfer of common stock can provide an important inducement to attract the younger generation into the family business and to reward them for their efforts. Thus, we believe that the estate freeze is a reasonable means of alleviating the transfer tax problem for the family business. However, there are other mechanisms which should be explored, such as lower tax rates on family owned farms and businesses, special valuation techniques, or longer-term payout for the estate tax with a low interest rate.

We understand and fully sympathize with the IRS problems in dealing with freezes under the current rules. Often the IRS does not learn that a freeze transaction took place until many years after the fact, making it extremely difficult to go back and verify the valuation. We recommend that in lieu of 2036(c), or during a deferral period, there should be a requirement that initial and subsequent estate freeze transactions be reported to the IRS currently, including a detailed analysis of the valuation and how it was determined. This would give the IRS the information it needs, would protect the gift tax revenue, and would allow time for a reasoned analysis of the entire transfer tax area.

We understand that a proposal has been made that estate freezes be allowed to continue, but that the preferred stock be valued under the assumption that noncumulative dividends will never be paid. This would be unacceptable to us because it does not address the fundamental problem. This would cause the common stock to be valued so highly as to trigger a gift tax that could not be paid by the typical small business. The result would still be that the family business would not remain in the family. Also, we cannot agree with another recent proposal which provides for a "safe harbor" if the preferred stock carries a cumulative dividend equivalent to the AFR. Many small businesses do not earn a rate of return equivalent to the AFR. Also, it seems unreasonable to relate a <u>dividend</u> which is paid in after tax dollars, to <u>interest</u> which would be paid in pre-tax dollars. If the AFR were 10% the company would need to earn 15.2% to pay a 10% preferred dividend.

We urge your committee to recommend that the Senate Finance Committee consider: (1) a postponement of the effective date of 2036(c), (2) institution of an information return reporting system for initial and subsequent estate freeze transactions, and (3) a study of the application of the

unified transfer tax system to small businesses and farm enterprises, specifically the ability of the donor to shift future appreciation in gift property to the donee. Such a postponement has ample precedent in the tax area and is desperately needed here for the following reasons:

1. The IRS interpretative notice released September 1, 1989 provides no guidance on the 1988 TAMRA correction period.

2. The December 31, 1989 correction deadline under TAMRA Section 3031(h)(4) is fast approaching, for freeze unwinding and TAMRA safe harbor recasting.

3. The IRS and taxpayer clearly face difficult problems with the initial freeze provisions of the 1987 Revenue Act and the subsequent freeze and safe harbor provisions of the 1988 Technical and Miscellaneous Revenue Act.

Information Return Reporting System

The information return reporting system would be designed to protect the revenue from abusive freeze transactions, pending completion of the study of the effect of the estate and gift tax system on small businesses. Presently, there is no specific information return reporting for an initial freeze transaction, particularly one accomplished by a sale rather than a gift transaction. Similarly, no information returns are required on subsequent freeze transactions including gifts restoring proportionality and retransfers by the initial freeze donee or purchaser outside the initial transferor's family group.

We recommend information returns for initial and subsequent transactions with a value exceeding a de minimis amount, perhaps $50,000, accompanied by a certified appraisal of the stock or other interest transferred, similar to that required for a charitable contribution of stock. Information returns for subsequent freeze transactions would reference the initial freeze transaction in order to facilitate IRS compliance activities.

Payroll Tax Deposits

Another area of the tax law that causes frustration among practitioners is the payroll tax deposit rules. We have found that many problems encountered by practitioners in dealing with the IRS have their genesis in the depository system; usually a payroll deposit. Because of the concentration of problems in the payroll tax area, we believe changes to the rules would make a substantial contribution to both

simplification and equity. We believe a change is necessary, not only because of the rather severe penalties and confusing deposit rules, but also because of the difficulties taxpayers and the IRS have in straightening out the problems.

Presently, the amount of the employer's liability for social security and withheld income taxes determines the frequency of the employer's deposits. To determine the amount and time of each deposit of tax, each return period is divided into a number of shorter deposit periods. If the amount of the social security and withheld income taxes at the end of the deposit period have reached a certain threshold amount, a deposit is required. If the amount of the tax liability has not reached the threshold amount by the end of the deposit period, it is carried over and added to the taxes for the next deposit period, and so on, until either a deposit requirement is triggered or the return period ends. After a deposit requirement is triggered, the amount deposited is no longer considered in calculating whether any subsequent deposits are required for the return period. The periods within which social security and withheld income taxes must be deposited are determined by reference to the amount of taxes required to be deposited, net of any advance-earned income credit amounts paid to employees.

To calculate whether a deposit is necessary, each month of the reporting period is divided into eight deposit periods ending on the 3rd, 7th, 11th, 15th, 19th, 22nd, 25th and last day of each month in the reporting period. Based on these periods, a deposit of tax is due if the combined social security and withheld income taxes reach the following levels during the applicable deposit period:

1. $3000 or more at the end of any deposit period. If at the end of any of the eight deposit periods during the month the employer's tax liability is $3,000 or more, the employer must deposit at least 95% of the liability within three banking days after the end of that period. If the deposit is triggered during the last month of the return period, the difference must be paid no later than the end of the following month. If the deposit is triggered during any month other than the last month of the return period, the difference must be paid no later than the first deposit that is required after the 15th of the following month.

2. $500 or more at the end of the month. If at the end of any month the total undeposited social security and withheld income taxes are more than $500 but less than $3,000, the employer is required to deposit such taxes within 15 days after the end of the month.

3. Less than $500 at the end of the month. If at the end of any month other than the last month of the reporting period the employer's undeposited tax liability is less than $500, the employer may carry the undeposited taxes forward to the following month to be applied and paid with any subsequent payments of tax.

4. Less than $500 at the end of the reporting period. If at the end of any reporting period the total undeposited social security and withheld income taxes are less than $500, the employer may pay the tax with the return or deposit it by the end of the following month to the appropriate financial institution.

By their very nature, these calculations seriously affect small businesses. We believe it would be far better to have specific dates rather than a variable date triggered by the amount of withholding. For example, any entity with fewer than 20 employees might be required to deposit every two weeks. The number of employees need not be 20, and this provision could be made revenue neutral by setting that number appropriately. Another approach might be to require payroll taxes to be deposited after each payroll period -- perhaps within three banking days following distribution of the payroll to the employees.

Another alternative would be to increase the present thresholds (less than $500, $500-$2,999, $3,000 or more) thereby reducing the number of required deposits and relieving the burden placed on the smallest business. A combination of alternatives is also a possibility, but what any of them would do would be to eliminate the various deposit requirements employers face when they surpass the different thresholds of aggregate amounts of undeposited taxes due. It is felt that a simplification in this area would reduce employer error as well as resultant IRS contacts.

A word of caution is necessary at this point. Any contemplated changes to the payroll rules must recognize the serious problem the IRS faces in the collection of payroll taxes. Although representing a clear minority of employers, the delinquency of many businesses is significant.

The IRS Office of the Assistant Commissioner (Collections) provides that as of June 1989, $18.2 billion was actively being collected. Of that amount, 27% or $4.9 billion represented delinquent payroll taxes. In comparison, the amount of delinquent payroll taxes at June 1988 was $4.3 billion which represents a $600 million increase in delinquent payroll taxes in the past year.

It is important that any legislative proposal be administratable and that they not seriously hamper IRS efforts to collect those taxes that are properly owed.

We also wanted to mention today the Treasury Department's Financial Management Service consideration of two replacement deposit systems -- the "Automated Federal Tax Deposit System" and the "Centralized Federal Tax Deposit System."

Treasury has previously stated that one of the major goals to be considered in a conceptual redesign of the Federal Tax Deposit System was the "Design must have the flexibility to meet user needs." This is still a key.

The present system is practical for all types of taxpayers to use. Under the proposal, however, many small taxpayers may not have the sophistication or resources to deal with an automated or electronic system. Other groups, like farmers or loggers, might not have unlimited access to a touch-tone telephone or computer. It is essential that any system provide equal access to all taxpayers.

Notwithstanding the above comments and additional specific problems with each scenario, the present system is too error prone. We agree that either scenario will minimize "errors and adjustments resulting from misplaced FTD coupons, lost coupons, incorrect posting of employers' accounts, incorrect classification of taxes, and delayed transfer of funds." Either scenario would be a tremendous improvement over the existing system.

Because of the inevitable problems that will be associated with the adoption of a new system during the phase-in period, sufficient direction must be given to the Internal Revenue Service for the imposition and abatement of potential penalties. For example, special tolerance levels should be developed for the phase-in period to minimize the unequitable imposition of penalties. In addition, IRS employees should be given a set of criteria unique to the phase-in period (above and beyond normal acceptance explanations) that would qualify for the reasonable cause abatement of penalties.

Failure By Corporations To Make Estimated Income Tax Payments

Another problem area of the tax law relates to the accurate computation of estimated tax payments for corporations. For the taxable years beginning after December 31, 1987, corporations generally are required to make estimated tax payments in an amount equal to the lesser of: (1) 90 percent of the tax shown on the return for the taxable year, or (2)

100 percent of the tax shown on the return of the corporation for the preceding taxable year.

Large corporations, however, are not allowed to use the latter rule of basing estimated tax payments at 100% of last year's tax. This provision also does not apply to any corporation if the preceding taxable year was a tax year of less than 12 months, or the corporation did not file a return for such preceding taxable year showing a tax liability.

The first part of this exception (must be a taxable year of 12 months) imposes a hardship since it is now necessary to determine the corporation's tax liability on a quarterly basis not only for the corporation's first taxable year but also for the second taxable year since it is a rare situation in which the first taxable year is a full 12 month year. This would also apply to those situations in which the corporation changed its year end.

Perhaps of greater concern is the second part of the exception, that is, the corporation must show a tax liability for the preceding taxable year in order to make a "safe" estimate for the current taxable year. It appears that a tax liability of zero is not a liability for this purpose. Therefore, the corporation will be required to compute its taxable income four times during the following year. This will be time consuming for the corporation or costly if the corporation asks its CPA firm to make the calculation. Furthermore, it will be necessary to be quite accurate in calculating the taxable income for each period since 90 percent of the tax shown on the return must be paid timely. The 90 percent requirement does not leave a lot of room for error or using "rough" estimates.

Many small corporations do not prepare monthly on even quarterly financial statements. Therefore, preparing estimated tax payments based on actual taxable income is almost as time consuming as preparing the tax return. It is not reasonable to expect or require these corporations to prepare the approximate equivalent of four additional tax returns for one year. Furthermore, the potential effect of present law can be inequitable. For example, assume Corporation A and Corporation B each have a tax liability of $250,000 for the current year. Neither is a "large corporation." Corporation A's prior year return showed taxable income of $100 and a tax liability of $15. Corporation B's prior year return showed a zero tax liability. Under present law, Corporation A is perfectly safe in paying a $15 estimated tax payment but Corporation B will be required to pay $225,000 in estimated tax payments.

The best solution to this problem is to allow for current year estimates to be made based on the tax liability of the prior year even if the prior year had a zero tax liability. This change would cost revenue since tax dollars would be received a few months later than under present law. However, it is important to note that this is merely a deferral of tax revenue, not a reduction on tax revenue. Furthermore, one might question whether Congress intended the results as discussed above when enacting the 1987 amendments. Therefore, a change which allows zero to be a valid estimate when the prior year had a zero tax liability should be allowed even if this is not a revenue neutral change. Other alternatives to present law treatment include the following:

1. Allow estimated tax payments to be made based on the greater of the tax paid in either of the prior two taxable years;

2. Allow the estimate to be based on the average of the prior three years' tax; and

3. If there is no tax liability in the prior year, a safe estimate would be to pay a flat minimum amount per quarter, for example, $100.

Alternative Minimum Tax

Portions of the current corporate alternative minimum tax (AMT) system impose an unfair burden on the small corporate business person. Like many areas of the Code, the present AMT system was designed with large corporations in mind, and did not consider the potential impact on the small business. Specifically, we are referring to the AMT adjusted current earnings calculation also known as the ACE adjustment. This purpose of the AMT and ACE adjustment is to assure that all corporations pay their fair share of federal income tax. The ACE adjustment achieves this purpose by capturing the "excess" deductions allowed in the determination of regular taxable income by adding them back to taxable income to calculate AMT. Unfortunately, the calculations required to compute the ACE adjustment are often extremely complex, requiring extensive professional time and excessive costs to the small business. In fact, for many of these entities, the costs of compliance will far outweigh any tax revenue produced by the ACE adjustment.

Fortunately, the House Ways and Means Committee recognized the AMT complexity problem earlier this year, and Chairman Rostenkowski introduced a bill to simplify the application of the minimum tax for corporations (H.R. 1761). This bill is designed to repeal ACE, and replace it with a simpler method

of capturing these tax preference amounts. This bill goes a long way toward providing a less complicated, more equitable method of calculating the AMT. Unfortunately, H.R. 1761 has not been included in the current House Reconciliation Bill, H.R. 3150, although the current bill does include a simplification of ACE, which is preferred to the current law ACE adjustment. As a result of the complexity of the current law, we strongly recommend that the Senate consider and adopt a proposal to simplify ACE either by supporting the House's ACE bill or development of ACE simplification legislation of its own.

UNICAP

Another area of concern is the complexity in compliance with the uniform capitalization rules as they relate to small businesses other than retailers and wholesalers. The issue is that the complexity and the attendant cost to comply with the uniform capitalization rules are unduly burdensome for most small businesses. The complexity introduced by the UNICAP rules has created tremendous problems for many taxpayers and the tax professionals who serve them. The cost to comply with the detailed calculations of additional inventory cost to be capitalized has in many cases approached, equaled, or exceeded the tax resulting from the new inventory rules.

It is the goal of the Institute and its members that there be full compliance with all statutory requirements for inventory capitalization. We believe that simplified elective statutory language could be drafted to achieve the same revenue estimates of the '86 tax act. One such option would be a "percentage table" which would approximate the complex calculations contained in current law. The small business, which must deal with UNICAP, could elect to use such a "percentage table" thereby avoiding unnecessary compliance cost while still capitalizing the dollar amounts anticipated under the 1986 Tax Reform Act. Another point of simplification would be to permit taxpayers who have complied with UNICAP rules to make an election to continue to use the capitalization rate they have developed for future years. To insure accuracy of this one-time determination, the rate could be based on a three-year base period. Again, this would reduce compliance burdens without sacrificing tax revenue dollars.

Self-employed Benefit Deduction

The Internal Revenue Code has provided for many years that employees may have their employers furnish to them hospital insurance covering the employee, the employee's spouse, and

the employee's dependents without the payment of such premiums constituting income to the employee. Accordingly, it is an accepted part of most of the American scene today that an employer will provide such coverage to the employee. Where this coverage is furnished, the employer will traditionally pay some part or all of the premiums for the employee. This payment does not constitute income to the employee. On the other hand, self-employed individuals have never been able to deduct any portion of those premiums as a direct deduction. The payment of these premiums by the self-employed person has constituted a medical expense, however, medical expenses are only deducted to the extent that they exceed 7.5% of the adjusted gross income of the employee. (This percentage has varied from time to time over the course of the recent years.)

At this time, Section 162(1) of the Internal Revenue Code provides that a self-employed individual may deduct from AGI an amount equal to 25% of the hospital insurance premiums where the premiums are for the benefit of the taxpayer, his spouse, and dependents. However, this deduction will not appply to years beginning after December 31, 1989, and thus the current year will witness the expiration of this particular deduction.

The AICPA recommends that the allowance of the Section 162(1) deduction be continued at a higher rate. Specifically, we suggest an extension of the deduction allowance with a gradual increase in the amount allowed to 100 percent. This provision should cover stockholder-employees of "S corporations" as well.

The Tax Reform Act of 1986 has been held as a measure which, among other things, is intended to eliminate discrimination of benefits and, further, to provide a fair and equitable treatment of all taxpayers. Obviously, at the present time, the Internal Revenue Code does discriminate against self-employed individuals insofar as they may only deduct 25% of those premiums, whereas an employee effectively deducts 100% since, where they are provided by the employer, the employer reports no part of that payment as income. Thus, in order to obtain an elimination of the discrimination between these two groups with respect to this item, the self-employed person should be permitted to deduct 100% of those premiums. No justifiable reasons can be advanced for having the self-employed person treated as a second-class citizen with respect to this item, and we strongly urge that the deduction be increased from 25% to 100% and, further, that this matter be made a permanent part of the Internal Revenue Code.

Senator BOSCHWITZ. Thank you.
Senator BOREN. Mr. Knight.

STATEMENT OF MICHAEL J. KNIGHT, MICHAEL KNIGHT, CPA, FAIRFIELD, CT, REPRESENTING NATIONAL SMALL BUSINESS UNITED

Mr. KNIGHT. It has been a long morning, Senators, and I will be very brief on Section 2036(c) and payroll taxes as they relate to small business. I'm a small business CPA and also a small businessman myself. I am a member of the NSBU and also I am on Tom Reardon's AICPA small business taxation subcommittee.

I have some examples for you. I have a comment from an expert, though, who I spoke with in preparation for this testimony, and he had a good analogy, I think, relating to Notice 89-99. He said he likened the notice to telling someone how to get to his house by telling them everywhere in America that he did not live. No matter how well traveled the person is, he is bound to miss something in his travels. [Laughter.]

He goes on to say that the people who wrote the rules are not well traveled in the business world, and the professionals who must execute the rules are cautioned to tread carefully.

As a small business CPA, we deal with a myriad of tax issues that affect the small businessowner. Section 89 was exceedingly complex, one that even as a tax professional I turned my head to and luckily it was repealed. Section 2036(c) I am finding the same frustration with. It is virtually impossible as a professional who feels that he keeps current to even begin to address the problems of Section 2036(c).

As a general rule, I would say that good tax law should have three characteristics. It should be simple. It should provide certainty regarding business decisions for small businessowners, and it should be an incentive for an owner to work hard and succeed. I believe that Section 2036(c) is complex, uncertain and it serves as a disincentive for the family business to stay in business.

Senator BOSCHWITZ. I would ask Senator Boren what does it mean? Simple? It's new word that hasn't arisen here in the Senate, particularly in tax matters. [Laughter.]

Mr. KNIGHT. However, the need for certainty has been addressed by a number of panel members, especially Mr. Goodner. I heard loud and clear, and I think even Art Hoffman said we need certainty—and that goes in the payroll area also. Certainty is what the businessowner is looking for. Uncertainty is what is killing him.

Let's look at the example of the Nickells. The real key point is that under Section 2036(c), she could have been certain under the old rules that $2 million of taxes is what she would have to pay. When Lyda dies and we do not know when she is going to die, there may be a valuation of $9.2 million. We cannot even be certain what the business valuation will be at death, since it hasn't occurred yet. But under the rule, because she did an installment sale, it would be included in her estate, and her heirs would have no idea what that amount would be until it happened. The uncertainty of the law is one of the major flaws of Section 2036(c) but it

happens to have all three characteristics of bad law: Complex, uncertainty, and a disincentive to business.

I have one quick anecdote. It was very interesting that it was timed with the testimony. We had the opportunity to go to propose to a new client last week. And I run into this family business, where parents had the meeting at the end of the day so all the family could be there, mom and dad and the two boys. Mom and dad started the business. He left a major corporation and has run the business for about 15 years. For 6 years he worked it out of his garage. Business doubled every year for the first 6 years.

The boys are now in the business. It is a very successful small business in the Connecticut area, and they are waiting for the boys to take over.

To show you the type of the classic profile of small business, they built their own building, but they did not have somebody build it. The boys took 1 year off from the business, saved the family $300,000, by constructing the building themselves. Mom and dad ran the business while the boys were constructing the building.

I am replacing another CPA who never even talked about succession planning to them. I said to them, you know, I am the bearer of bad news. I said are you aware of new tax law. They had no idea what I was talking about. No idea. So, they are not aware of it. Of course, as a small businessowner, very few are. The ones who are here are the unique ones who have taken an interest in it. The former CPA was not aware of it. I am aware of the law, but I do not have a solution for the client. And it is that type of frustration that makes the professional lose faith in the system.

I've seen the erosion of all the planning opportunities for small business, starting with the White House Conference where I suggested that the elimination of general utilities was probably the worst thing that could ever happen to small business. But general utilities was eliminated. We now have the built-in gains on S corporations. We have erosion of the ESOP rules and we have Section 2036(c). There is just a confluence of tax laws geared specifically at small business that is going to make them throw their hands up and say why continue. With all the aggravation, why continue?

Payroll taxes. I will quickly discuss on that. I will give you a personal experience there too.

It's September 1989. I am still fighting penalties from September 1988 for my business. And it had nothing to do with errors on my part. One deposit that we made the bank lost. The other one, there was fraud at the bank, and the payment was never transferred on to the Federal Reserve Bank. But since I am the person who made the deposit, it is my obligation. I am fighting the penalties. Believe it or not. This is a year later.

I spend more time with problem resolutions, the IRS special problem resolution office, on payroll penalties than any other single issue in my office, including 1120 audits and 1040 audits, because we fight every penalty. And guess what. Ninety-nine percent of our penalties are waived, but in the meantime it takes 8 months. I tie up IRS resources. I tie up my resources and I tie up the client's resources. Payroll tax reform or expansion is sorely needed for the small business owner.

Those are my comments.

Senator BOSCHWITZ. How big a firm do you have?

Mr. KNIGHT. I have eight people who serve 200 business clients that range from probably one employee to a top of 25 employees.

And each one of them on the payroll tax issue—they make mistakes. They are human. They do not know. They cannot keep track. They do not know what an—does anybody know what an 8 monthly deposit period is? Did you ever try explaining that to a taxpayer? My wife does not understand it, and she has to make the payroll deposits.

[The prepared statement of Mr. Knight follows:]

MICHAEL J. KNIGHT, C.P.A.

FAIRFIELD, CONNECTICUT 06430

TESTIMONY

FOR NSBU AT SENATE SMALL BUSINESS SUBCOMMITTEE HEARING

WEDNESDAY, SEPTEMBER 13, 1989

MORTIMER KAPLAN, FORMER COMMISSIONER OF THE IRS, WHO TAUGHT TAX LAW AT THE UNIVERSITY OF VIRGINIA LAW SCHOOL ASKED HIS INCOMING FRESHMEN CLASS WHAT THE DIFFERENCE BETWEEN A TAX COLLECTOR AND A TAXIDERMIST. MR. KAPLAN DEADPANNED, THE TAXIDERMIST LEAVES THE HIDE!

GOOD MORNING SENATORS:

I AM PROUD TO BE HERE ON BEHALF OF MY FAVORITE GROUP, SMALL BUSINESS, FOR I BELIEVE THERE IS NO GROUP OR ISSUE THAT IS MORE CRUCIAL TO THE SURVIVAL OF OUR ECONOMY. SAVING THE HIDES OF SMALL BUSINESS IS A MAJOR GOAL OF MINE. I AM SURE, I DO NOT NEED TO REPEAT THE VARIOUS STATISTICS ABOUT HOW SMALL BUSINESS IS THE "ENGINE OF THE ECONOMY", ESPECIALLY IN TERMS OF EMPLOYMENT. MY COLLEAGUE FROM NSBU, JOHN GALLES, AND OUR ATTORNEYS, NEECE & CATOR, HAVE ABLY DONE THAT BEFORE. MY COMMENTS TODAY ARE FROM TWO STANDPOINTS:

1) AS A SMALL BUSINESS OWNER MYSELF - MY FIRM HAS EIGHT PEOPLE

AND 2) AS A PROFESSIONAL WHO NOT ONLY HAS TO KEEP UP WITH WHAT SEEMS TO BE A NEVER ENDING STREAM OF TECHNICAL TAX LAW CHANGES BUT ALSO AS A PERSON WHO MUST ADVISE FAMILY BUSINESS CLIENTS HOW TO "PASS THE BUSINESS ON."

MY TERMINOLOGY FOR DESCRIBING TECHNIQUES BY WHICH SMALL BUSINESS OWNERSHIP IS TRANSFERRED IS "EXIT VEHICLES FOR SMALL BUSINESS." THERE WAS A TIME BEFORE THE VARIOUS 1980 TAX LAW CHANGES WHEN A SMALL BUSINESS OWNER COULD TRANSFER HIS BUSINESS INTEREST IN A VARIETY OF WAYS WITHOUT CONFISCATORY TAX COSTS. SOME OF THE MORE COMMON WAYS WERE:

(1) SALE VIA A LIQUIDATION UNDER THE "GENERAL UTILITIES" DOCTRINE.

(2) RECAPITALIZATION OR SALE BETWEEN FAMILY MEMBERS.

(3) SALE VIA AN EMPLOYEE STOCK OWNERSHIP PLAN (ESOP).

GENERALLY THE RECAPITALIZATION ROUTE WAS USED TO KEEP A SMALL BUSINESS WITHIN FAMILY MEMBERS. THE OTHER OPTIONS WERE GENERALLY USED IN NON-FAMILY BUSINESS TRANSFERS, BUT ALLOWED THE SMALL BUSINESS PERSON AT THE END OF HIS CAREER TO REAP THE REWARD OF HIS LIFE LONG EFFORTS.

BECAUSE OF THE REPEAL OF GENERAL UTILITIES AND SECTION 2036(C) CHANGES, A SMALL BUSINESS OWNER CANNOT AFFORD TO SELL OR TRANSFER HIS BUSINESS WITHOUT INCURRING A DOUBLE TAX.

AS A RESULT THE VIBRANT EXCHANGE OF SMALL BUSINESSES BETWEEN OWNERS AND WOULD BE ENTREPRENEURS HAS VIRTUALLY STOPPED. SO HOW ARE SMALL BUSINESSES TRANSFERRED? ONLY ONE GROUP - BIG BUSINESS OR FOREIGN BUYERS CAN AFFORD TO ACQUIRE SMALL BUSINESS. WHAT HAPPENS WHEN BIG BUSINESS BUYS UP SMALL BUSINESS? MOSTLY THINGS THAT DO NOT BODE WELL FOR THE LOCAL OR NATIONAL ECONOMY.

(1) THINGS LIKE: IMMEDIATE LAYOFFS

(2) THINGS LIKE: CONSOLIDATION WITH ANOTHER DIVISION WITH THE RESULT THAT THE BUSINESS IS CLOSED DOWN

(3) THINGS LIKE: DOWNSIZING OF THE LABOR FORCE THROUGH CONSOLIDATION OR OFFSHORE MANUFACTURING

I CAN ONLY REINFORCE THE FRUSTRATION WITH WASHINGTON THAT LYDA NICKEL HAS DEPICTED. BUT I WOULD SAY THIS FRUSTRATION EXISTS IN THE MAJORITY OF MY SMALL BUSINESS CLIENTS.

THE PROBLEM WITH OBSCURE TAX LAW CHANGES WHICH ONLY AFFECTS A SMALL BUSINESS OWNER AT TIME OF RETIREMENT IS THAT UNTIL THE THOUGHT OF RETIREMENT HITS, NO OWNER ANTICIPATES THE COST THAT TRANSFERRING THE BUSINESS WILL ENTAIL. AN EXPERIENCE I HAD IN 1984 WILL ILLUSTRATE THIS POINT. I ATTENDED THE WHITE HOUSE CONFERENCE FOR SMALL BUSINESS IN 1984. A BREAKOUT SESSION DEALING WITH TAX CHANGES MET FOR EIGHT (8) HOURS OVER TWO (2) DAYS TO DISCUSS THEIR RECOMMENDATIONS. THIS SESSION WAS ATTENDED BY APPROXIMATELY 500 SMALL BUSINESS OWNERS FROM AROUND THE COUNTRY. I RAISED THE ISSUE THAT THE PROPOSED REPEAL OF THE "GENERAL UTILITIES" DOCTRINE WAS ONE OF THE MOST IMPORTANT ISSUES A SMALL BUSINESS OWNER COULD EVER FACE. A FEMALE BUSINESS OWNER STOOD UP AND REINFORED MY COMMENTS. AND SHE DID SO, NOT OUT OF KNOWLEDGE OF THE LAW, BUT BECAUSE SHE HAD JUST SOLD HER BUSINESS AND HER ADVISORS RECOMMENDED THE UTILIZATION OF THE "GENERAL UTILITIES" TECHNIQUE.

SECTION 2036(C)

THE SAME SUCCESSION COMPLEXITIES THAT SURROUNDED "GENERAL UTILITIES" IS EVEN MORE PRESENT IN SECTION 2036(C). THE LAW IS OVERLY COMPLEX EVEN WITH THE RECENTLY RELEASED NOTICE 89-99 AND INCOMPREHENSIBLE TO NOT ONLY SMALL BUSINESS OWNERS BUT GENERAL PRACTITIONERS LIKE MYSELF WHO DEAL WITH MYRIAD TAX ISSUES FOR SMALL BUSINESS WITHOUT THE BENEFIT OF A SPECIALIST IN HOUSE. DOES NOTICE 89-99 REALLY SOLVE THE SECTION 2036(C) PROBLEMS? I CONFESS TO NOT HAVING TIME TO DISECT AND FULLY COMPREHEND THE NOTICE. I WILL RELY ON THE EXPERTS WHO WRITE IN MY PROFESSIONAL PUBLICATIONS TO DO THAT. HOWEVER ONE EXPERT I SPOKE WITH IN PREPARATION FOR THIS HEARING, LIKENED THE NOTICE TO TELLING SOMEONE HOW TO GET TO HIS HOUSE BY TELLING THEM EVERYWHERE IN AMERICA THAT HE DID NOT LIVE. NO MATTER HOW WELL TRAVELED THE PERSON IS, HE IS BOUND TO MISS SOMETHING IN HIS TRAVELS. THE PEOPLE WHO WROTE THE RULES ARE NOT WELL TRAVELED IN THE BUSINESS WORLD. THE PROFESSIONALS WHO MUST EXECUTE THE RULES ARE CAUTIONED TO TREAD CAREFULLY.

LET'S BRIEFLY LOOK AT HOW DANGEROUS THE EXCURSION WILL BE.

A SEPTEMBER 8, 1989 WALL STREET JOURNAL ARTICLE SAYS ESTATE RULING PROVIDES SEA LANES - WITH ICEBERGS. AS RICHARD L. DEES, AUTHOR OF SECTION 2036(C) - THE MONSTER THAT ATE ESTATE PLANNING AND INSTALLMENT SALES, BUY SELLS, OPTIONS, EMPLOYMENT CONTRACTS AND LEASES, SAYS:

> "IN THE PREPARATION OF THIS ARTICLE, IT HAS BEEN MY INTENT TO FOCUS SOLELY ON THE STATUTORY LANGUAGE AND SUPPORTING LEGISLATIVE HISTORY IN APPLYING SECTION 2036(C) TO THE TRANSACTIONS. MY CONCLUSION AS TO THE BREADTH OF SECTION 2036(C) IS MUCH NARROWER THAN THE BREADTH IMAGINED BY OTHERS. THIS IS A LUXURY AFFORED ME AS A COMMENTATOR, BUT DENIED ME AS AN ESTATE PLANNER. MY CLIENTS CAN ILL AFFORD RELYING ON MY COGENT ANALYSIS IF A LESS RISKY "SAFE HARBOR" EXISTS. FOR THIS REASON, THE LAW UNDER SECTION 2036(C) WILL DEVELOP HAPHAZARDLY. WELL INFORMED PLANNERS WILL AVOID ITS REACH. ONLY THE ILL INFORMED AND AGGRESSIVE WILL DIRECTLY CHALLENGE THE BREADTH OF THE STATUTE. THE AUDIT LOTTERY WILL MEAN THAT MANY OF BOTH THE ILL INFORMED AND AGGRESSIVE WILL ESCAPE DETECTION." (EMPHASIS MINE.)

A RECENT MEETING I HAD ON THURSDAY, SEPTEMBER 7, 1989 WITH A POTENTIAL NEW CLIENT ILLUSTRATES MR. DEE'S POINT.

I REFER TO THIS AS THE CLASSIC SMALL BUSINESS PROFILE. A WIFE AND HUSBAND STARTED THE BUSINESS OVER _____ YEARS AGO AFTER THE HUSBAND LEFT A MAJOR CORPORATION. THEY OPERATED OUT OF THEIR HOUSE FOR YEARS. THE BUSINESS DOUBLED EVERY YEAR FOR THE FIRST SIX YEARS. THE SONS GREW UP AND BECAME PART OWNERS OF THE BUSINESS. THE BUSINESS CONTINUED TO EXPAND. THE SONS TOOK A YEAR OFF FROM THE BUSINESS TO CONSTRUCT THEIR NEW 8,000 SQUARE FEET OFFICE BUILDING SAVING THE FAMILY $300,000. THE PARENTS ARE OLDER NOW AND BEGINNING TO THINK ABOUT RETIREMENT. MY FIRST QUESTION TO THEM WAS: "HOW ARE YOU GOING TO PASS THE BUSINESS ON TO YOU SONS UNDER THE NEW TAX CHANGES?" THEY HAD NO IDEA WHAT I WAS TALKING ABOUT. I'M NOT SURE I HAVE THE ANSWER FOR THEM BUT I FEEL LUCKY ENOUGH JUST TO BE ABLE TO ASK THE RIGHT QUESTIONS, LET ALONE FORMULATE THE ANSWER. BUT THE MORE INTERESTING OBSERVATION IS HOW WOULD THEY EVER HAVE KNOW ABOUT SECTION 2036(C) UNTIL IT IS TOO LATE? WHEY DIDN'T THEIR PREVIOUS CPA EVEN MENTION IT TO THEM? IF THE PROFESSIONALS DON'T HAVE A CHANCE TO KEEP UP, HOW CAN WE EXPECT THE SMALL BUSINESS OWNER TO?

I WOULD LIKE TO SHARE ADDITIONAL COMMENTS BY MR. DEES IN HIS TESTIMONY BEFORE THE SENATE FINANCE COMMITTEE FOR HIS COMMENTS ARE POIGNANT.

THE ISSUE IS WHAT WAS 2036(C) TRYING TO ACCOMPLISH? HOW MUCH ABUSE IS THERE FROM A SMALL BUSINESS STANDPOINT? HOW MUCH REVENUE WAS REALLY LOST FROM SMALL BUSINESS ABUSE? HOW MUCH REVENUE CAN REALLY BE GAINED FROM SMALL BUSINESS BY THESE CHANGES? I CAN MAKE AN ANALOGY TO RECENT CHANGES MADE TO ESOPS.

THE SPONSOR OF RECENT ESOP CHANGES STATES THEY WERE MADE BECAUSE ESOPS HAVE BEEN ABUSED BY THE WALL STREET TYPES. WHAT IS NOT SAID IS THAT ESOPS ARE ONE OF THE BEST TOOLS FOR SUCCESSION PLANNING FOR SMALL BUSINESS. HOWEVER, FOR FAMILY BUSINESSES, EVEN ESOPS DISCRIMINATE. RICHARD DEES SUGGESTS THAT SECTION 2036(C) WAS INACTED "IN EXCHANGE FOR THE FAILURE TO ENACT A PROVISION DENYING GIFT TAX DISCOUNTS TO ENTIRELY FAMILY OWNED BUSINESSES".

IF 2036(C) IS THE CURE, THE PATIENT MIGHT AS WELL KILL HIMSELF. IF THE OBJECTIVE WAS TO END MINORITY DISCOUNTS, WHY NOT JUST DO IT. ESOPS REQURE FAIR MARKET VALUE VALUATIONS EVERY YEAR, WHY NOT USE SOME MODIFICATION OF THE ESOP COMPLIANCE RULES AND APPLY IT TO SMALL BUSINESS TRANSFERS.

L. HENRY GISSEL, JR. OF THE ABA WROTE TO SENATOR LLOYD BENTSEN AND HAS OFFERED ALTERNATIVES TO SECTION 2036(C). (COPIES OF HIS COMMENTS AND PROPOSALS ARE ATTACHED.)

ADA ROUSSO FROM PRICE WATERHOUSE WROTE TO MAURICE FOLEY, TAX COUNSEL TO THE FINANCE COMMITTEE WITH PROPOSED CHANGES. (COPIES OF HER COMMENTS ARE ATTACHED.)

MANY PEOPLE HAVE CALLED FOR OUTRIGHT REPEAL OF SECTION 2036(C) SIMPLY BECAUSE OF ITS DISCRIMINATION AGAINST SMALL BUSINESS.

SENATOR GEORGE MITCHELL RESPONDED TO THEODORE H. BRODIC, A SMALL BUSINESS OWNER IN MASSACHUSETTS AND STATES THAT BECAUSE SMALL FAMILY HELD BUSINESSES ARE A VALUABLE, JOB CREATING ASSET IN THIS NATION, TAX LAWS OUGHT TO ASSIST, NOT PENALIZE. (COPY OF LETTER ENCLOSED.)

REPRESENTATIVE BILL ARCHER HAS SPONSORED A BILL CALLING FOR REPEAL OF SECTION 2036(C).

AND I, MICHAEL J. KNIGHT, SMALL BUSINESS CPA, CALLS FOR REPEAL OF SECTION 2036(C). TO DO LESS WOULD BE TO IMPOSE THE MOST SEVERE PENALTY OF ALL ON A SMALL BUSINESS OWNER, PASSING THE TAX BILL ONTO UNSUSPECTING HEIRS.

Senator BOREN. I know members of the Finance Committee that still do their own taxes which would be reassuring to all of you. We have finally gotten it to the point that we made sure that everyone is going to stay employed that has expertise in this field. But some of them would even dare try it.

I want to thank all of you for being here today. Also, I think it is a very good idea for us to have heard some thoughts about what may be thrown at us in the Finance Committee when we push repeal. But alternatives may be presented and why those alternatives won't work. That is important for us to know too because that is the next route of defense by those in the bureaucracy that will want to keep this provision is to say, well, there are other ways around this other than repealing it. But I think again repeal of it is the best with some additional reporting requirements at the time that the freeze takes place seems to me to be a much more effective way of preventing abuse and not getting us into other alternatives. They are not going to fix the problem. They are going to create other kinds of problems for us or allow people to pretend that they fixed the problem when they haven't.

So, Senator Boschwitz and I will discuss this with Chairman Bumpers too to see the manner in which he feels that this Committee could appropriately make some communication to our colleagues on the Finance Committee. As I say, some of us also serve on the Finance Committee. Unfortunately, I believe only two or three of us. So, I think it is important we try to get an expression from the whole Small Business Committee to the Finance Committee.

Senator BOSCHWITZ. Nobody on our side I don't think——

Senator BOREN. Senator Wallop used to be. Isn't Grassley back on? No, he's still not? Senator Symms came back on. That's right. Senator Baucus serves on the Finance Committee.

But we will do our very best to try to get something done about this. It is something that is a problem that I understood was a problem. It flies in the face of what Rudy Boschwitz and I and Malcolm Wallop and others have worked so hard to try to move us in the other direction, strictly as it impacted estate taxes and preservation of small businesses. And they have come in the back door on us again when they rewrote the technical sections of the Tax Reform Bill and the follow-on acts.

And a lot of this actually happens in staff drafting. I have actually won amendments in Committee to find out that I lost when they drafted it. [Laughter.]

As was mentioned, one time I even had an experience since I have been a Senator of going in and I had written out the text of the amendments myself, and the Committee actually voted on the text of the amendment only to have non-elected staff change the text of the amendment. I had the temerity to attend a staff meeting to suggest that they had acted illegally because none of them had had their names on the ballot. And I was told that it was not appropriate for a Senator to attend a staff meeting. [Laughter.]

This was during my membership on the Finance Committee. And Senator Long was Chairman at that time. I went straight from being thrown out of the staff meeting to Senator Long's office, and I was readmitted to the staff meeting about 2 minutes later. And

my amendment was rewritten as the Committee passed it, not as the staff voted on it having not been elected constitutionally to serve as Members of the Senate.

But this happens and it happens in conference committees all the time where staff members—sometimes they vote on it even before the actual language has been developed and you get into things like this. And it is said this is noncontroversial, cats and dogs, nickels and dimes. You can come up with this list. It will make this bill fly, and that is what happens.

Listening to the hearing expressed firsthand the kinds of problems that are created for your clients, hearing some of them themselves speak, it just redoubles the intensity of my feeling that we have to do something about this. We are really striking at the very heart of what I think of as our social and economic system both, small businesses that are parts of communities. I have experienced what happens when you lose that local owner that is a part of the community. All of a sudden a lot of other things suffer, the support for the local charities that have always been supported by these companies that are the first one to make the contribution. Then they go to the other people in the community and say now match this, and so on. The anchors are taken away from communities when this happens. So, we have gone through a lot of that in my State and really borne the brunt of it.

So, all I can say to you is we have the commitment to do everything we possibly can. Obviously the Members of this Committee are unfortunately not 100 Members of the Senate on this Committee, but they are people that have shown sensitivity in the past. Sometimes we succeed and sometimes we fail at an effort, but I can tell you we are going to make a big effort. I hope we will succeed. If we do not succeed, the folks on the other side of this issue are going to have enough scars to know they have been in a fight when it is over. [Laughter.]

So, we will do what we can do.

Senator BOSCHWITZ. I would say that the number of Senators who were here this morning indicates the interest that we do have in all of this.

I would also add that maybe Mr. Michaletz and Mr. Hoffman, the members of the association, the American Institute of Certified Public Accountants—you were part of the group that dealt with these issues. Perhaps you could draw up some language with respect to the moratorium that you suggest.

Mr. HOFFMAN. We would be happy to, Senator, and we would work with your staff toward it. We are very willing to.

Senator BOREN. Thank you all very, very much.

[The prepared statements of Senators Grassley and Dixon follow:]

STATEMENT BY SENATOR CHARLES E. GRASSLEY

MR. CHAIRMAN:

I COMMEND YOU AND SENATOR BOSCHWITZ FOR CONVENING THIS HEARING ON THE PROBLEMS REGARDING SMALL BUSINESS TAXATION. ISSUES SUCH AS THE ESTATE FREEZE, FICA REPORTING, PAYROLL TAXES, THE FUTA TAX AND HEALTH INSURANCE FOR SELF-EMPLOYED INDIVIDUALS ALL REPRESENT MAJOR PROBLEMS FOR AMERICAN SMALL BUSINESS.

TAX REFORM WAS INTENDED TO GIVE INDIVIDUALS AND SMALL BUSINESSES A BREAK. UNFORTUNATELY, A NUMBER OF SMALL BUSINESSES ARE FINDING THEMSELVES GOING BROKE AS THEY ATTEMPT TO COMPLY WITH OUR OFTEN HIGHLY COMPLEX, AMBIGUOUS TAX LAWS.

A MAJOR ISSUE BEFORE US TODAY CONCERNS INTERNAL REVENUE CODE SECTION 2036(C) AND ITS ELIMINATION OF THE SO-CALLED ESTATE TAX FREEZE. PRIOR TO 1987, FAMILY-OWNED BUSINESSES COULD FOREGO POTENTIALLY DEVASTATING FUTURE INHERITANCE TAXES BY RECAPITALIZING THE BUSINESS AND "FREEZING" THE VALUE OF THE PARENTS' OWNERSHIP, WHILE PASSING OWNERSHIP RIGHTS ON THROUGH TO THE CHILDREN WHO IN MANY CASES ACTUALLY RUN THE BUSINESS. THE PARENTS' FUTURE DEATHS WOULD NOT, THEREFORE, TRIGGER HUGE ESTATE TAXES.

UNDER SOME PRESUMPTION THAT ESTATE FREEZE TRANSACTIONS INVOLVED AN UNDUE AMOUNT OF FRAUD, THE TAX COMMITTEES ELIMINATED ESTATE FREEZES IN 1987. UNFORTUNATELY, NO HEARINGS WERE HELD AND VERY LITTLE WAS UNDERSTOOD ABOUT THE PROBLEM.

I HAVE RECEIVED NUMEROUS LETTERS FROM CONSTITUENTS IN IOWA WHO FEAR THE POTENTIALLY DEVASTATING EFFECTS OF THE CURRENT LAW. I HAVE, CONSEQUENTLY, COSPONSORED LEGISLATION TO RESOLVE THE CURRENT PROBLEM. HOPEFULLY, THIS COMMITTEE WILL BE INSTRUMENTAL IN DEVELOPING A RECORD THAT WILL ASSIST THE CONGRESS IN ALLEVIATING UNNECESSARY BURDENS SUCH AS SECTION 2036(C) PLACED ON SMALL BUSINESSES THROUGH THE TAX CODE.

I THANK THE WITNESSES FOR THEIR PARTICIPATION AND I LOOK FORWARD TO THEIR TESTIMONY.

OPENING STATEMENT OF

SENATOR ALAN J. DIXON

SENATE SMALL BUSINESS COMMITTEE

SEPTEMBER 13, 1989

MR. CHAIRMAN, I AM PLEASED TO BE HERE THIS MORNING AS THE SENATE SMALL BUSINESS COMMITTEE REVIEWS THE MANY TAX ISSUES CONFRONTING SMALL BUSINESS CONCERNS WHICH IMPACT THEIR GROWTH AND DEVELOPMENT. THIS IS AN EXTREMELY IMPORTANT AND TIMELY TOPIC.

SMALL BUSINESSES CONTINUE TO LEAD OUR NATION IN PROVIDING NEW JOBS FOR OUR DIVERSE WORKFORCE, MAKING THEM A SIGNIFICANT CONTRIBUTOR TO OUR ECONOMY. OUR ECONOMY, HOWEVER, IS UNDERGOING RAPID CHANGES AND MAJOR CHALLENGES THAT SMALL BUSINESSES MUST SUCCESSFULLY RESPOND TO IN ORDER TO SURVIVE. TECHNOLOGICAL ADVANCES ARE MAKING THE WAYS WE PREVIOUSLY OPERATED OBSOLETE. THE AMERICAN WORKFORCE IS AGING AND SHRINKING. AT THE SAME TIME, INTERNATIONAL COMPETITION IS MAKING INROADS IN OUR TRADITIONAL MARKETS, AND IN MANY INSTANCES, ERECTING UNFAIR BARRIERS TO OUR PRODUCTS.

ALTHOUGH OUR INTERNAL REVENUE CODE MUST BE FAIR AND EQUITABLE, IT IS CERTAINLY NOT NEUTRAL. THE TAX CODE CAN EITHER STRAIGHT-JACKET THE OPPORTUNITIES PRESENTED TO SMALL BUSINESS CONCERNS, OR IT CAN ENABLE THEM TO RATIONALLY AND REASONABLY RESPOND TO THESE CHALLENGES. THE PREFERRED COURSE IS CLEAR. OUR TAX CODE SHOULD FOSTER RESEARCH AND DEVELOPMENT, ENCOURAGE

INVESTMENT, AND GENERATE THE CONDITIONS ESSENTIAL FOR GROWTH AND PROGRESS FOR ALL BUSINESS CONCERNS -- LARGE AND SMALL ALIKE.

UNFORTUNATELY, FAR TOO OFTEN OUR TAX CODE HAS IMPOSED OBSTACLES, RATHER THAN INCENTIVES, TO CONTINUED ECONOMIC GROWTH AND PROSPERITY. AS WE ARE ALL PAINFULLY AWARE, SECTION 89 HAS INFLICTED A BURDEN THAT IS BOTH UNREASONABLE AND UNCONSCIONABLE ON SMALL BUSINESSES THROUGHOUT OUR NATION.

ANOTHER AREA OF MAJOR CONCERN WITH THE CODE PERTAINS TO THE TAX TREATMENT OF SELF-EMPLOYED INDIVIDUALS. THE TAX CODE PROVIDES 100% DEDUCTIBILITY FOR HEALTH INSURANCE PREMIUMS FOR ALL FORMS OF BUSINESS OWNERSHIP -- ALL FORMS WITH THE EXCEPTION OF THE SELF-EMPLOYED. SELF-EMPLOYED INDIVIDUALS, THAT IS, SOLE PROPRIETORS AND PARTNERS OF SMALL BUSINESSES, AS WELL AS FARMERS AND RANCHERS, ARE PERMITTED ONLY A 25% DEDUCTION FOR HEALTH INSURANCE COSTS. THIS TREATMENT IS FUNDAMENTALLY INEQUITABLE -- AND TO MAKE MATTERS EVEN WORSE, THE 25% DEDUCTION IS SCHEDULED TO EXPIRE AT THE END OF THIS YEAR!

THE OPPORTUNITY TO HEAR FROM THE ADMINISTRATION, PRACTITIONERS, AND SMALL BUSINESSES ON THESE ISSUES WILL BE INFORMATIVE AND HELPFUL. I LOOK FORWARD TO THE TESTIMONY OF OUR DISTINGUISHED WITNESSES. THANK-YOU, MR. CHAIRMAN.

Senator BOREN. We will now adjourn.

Thank you all for making the effort to come. We know that it takes time out from your own businesses and other responsibilities. We appreciate it very much.

[Whereupon, at 12:35 p.m., the Committee was adjourned.]

APPENDIX

Coalition for Health Care Equity

600 Maryland Ave. S.W., Suite 800
Washington, DC 20024

SUBMITTED STATEMENT
OF
THE COALITION FOR HEALTH CARE EQUITY

BEFORE: Senate Small Business Committee

DATE: September 13, 1989

The IRS Code gives a distinct advantage to corporations, as opposed to sole proprietorships and partnerships. For corporations all health insurance costs are deductible. However, the self-employed, operating as either sole proprietorships or partnerships can only deduct the health insurance costs attributable to their employees. The owner's costs are only partially deductible despite the fact that he/she is part of the business' group health plan.

As the attached chart indicates, this arbitrary distinction has been a disincentive for these businesses to obtain health insurance -- a disincentive based solely upon the legal structure of the firm.

The Tax Reform Act of 1986 made a move in the right direction by allowing a twenty-five percent deduction for the health insurance costs of the self-employed. However, this partial deduction still discriminates against non-incorporated businesses.

According to a study by the Employment Benefits Research institute (EBRI), over twenty-two percent of self-employed business owners carry no health insurance. These business owners roughly make up seven percent of all uninsured workers and employ 32% of the American workforce. A significant portion of the health insurance gap that exists could be narrowed simply by equalizing treatment for health insurance expenses for incorporated and unincorporated businesses.

Unfortunately, even the minimal 25% deduction is at risk. The provision is set to expire at the end of this year. Such a move is not only shortsighted, it is counterproductive public health policy, negating serious efforts to reduce the number of uninsured Americans. It is counterproductive public health policy.

Affordability has become the watchword in the health care area. The preservation and expansion of the deduction for the costs of health insurance premiums for self-employed individuals accomplishes two important goals:

1. Provides an incentive for firms to provide health insurance. An incentive for the owner translates into employee coverage because of the advantage of group policy discounts versus higher individual policies.

2. Provides an offset against increasing costs of doing business. Such an offset will ensure that firms now offering coverage will retain that coverage.

The Coalition for Health Care Equity, comprised of over 30 business and professional groups, strongly supports the preservation of the 25% deduction for self-employed and sole proprietorships and its extension to the full amount enjoyed by incorporated businesses.

The IRS maintains that nonincorporated businesses are somehow less of a business than corporations, yet according to the U.S. Bureau of Census, there were over 7 million self-employed individuals in 1984. This percentage has increased dramatically since 1970 and has continued to grow through 1989. This figure is significant because of its limited definition – individuals whose nonincorporated business is their primary work activity, not a side business; not a hobby but their primary source of income; and expenditure of individual time and efforts. In addition, the Small Business Administration's 1988 State of Small Business Report states that:

> there were over 19 million (nonfarm) small businesses in the United States ... Of the over 2.9 million corporations, 97.2 percent have fewer than 100 employees ... One of the most dramatic small business developments in recent years has been the increase in the number of persons who are self-employed. Since 1970, the non-farm self-employed have increased 50 percent ... (and) ... had receipts of about $500 billion in 1983.

Of the entire workforce, the U.S. Department of Census reveals that 2.7% are incorporated self-employed, 3.0% are wage and salary workers with self employment, .4% are unpaid family workers, 7.8% are unincorporated self-employed and the balance are the traditional wage-and-salary worker.

The extension of the 100% deduction, or a phase-in, is clearly targeted to the almost 8% of the workforce who are unincorporated self-employed operating their business as a full time venture, not as a side business. A large portion of the affected self-employed are also in vulnerable agricultural activities.

Self-employment serves as the training ground for the nation's entreprenuers, the mainstay of the farming community, and the preferred business organization for the nation's professionals. The continued economic expansion and our world-wide competitive position relies heavily upon the activities of these individuals. Allowing this deduction to expire discriminates against the self-employed and is counterproductive health, as well as economic, policy.

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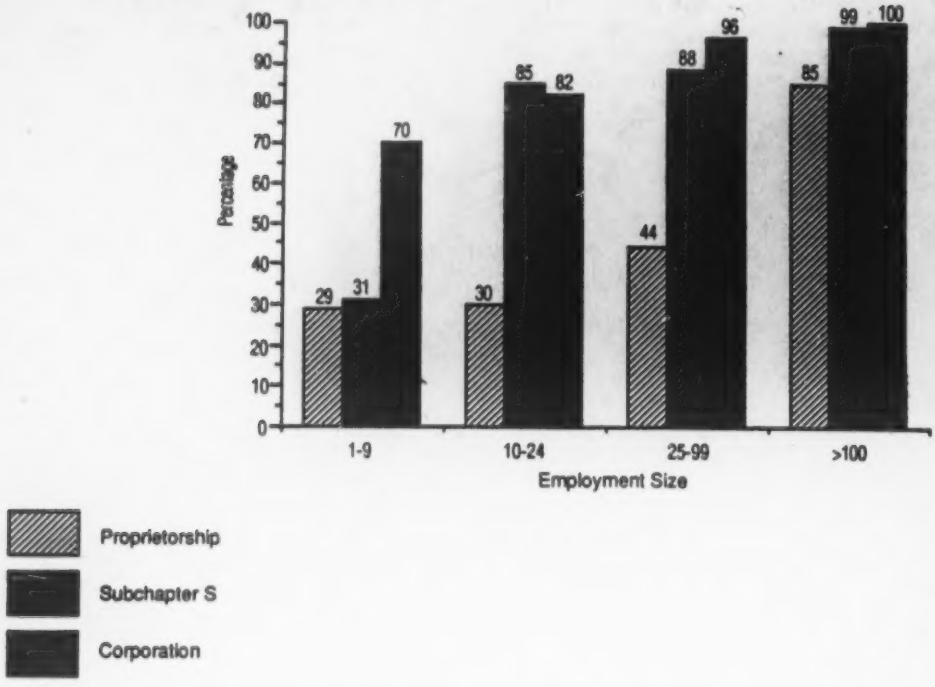
Attachments

Percentage of Firms that Sponsor Health Plans by Employment Size and Form of Ownership,1985



Source: U.S. Small Business Administration, 1987.

Coalition for Health Care Equity

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U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF CHIEF COUNSEL FOR ADVOCACY

September 8, 1989

Hon. Alan J. Dixon
United States Senate
Washington, D.C. 20510

Dear Mr Chairman:

At your hearing yesterday morning we discussed the imposition of information collection burdens on small employers. One example of a regulation that has a significant impact is Section 89. As you and Senator Kasten requested, I am enclosing a copy of a letter to the Office of Management and Budget describing our analysis of the burdens under Section 89 for inclusion in the record.

Again, I appreciate having the opportunity to present my views to you.

Very truly yours,

Frank S. Swain
Chief Counsel for Advocacy

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF CHIEF COUNSEL FOR ADVOCACY

May 4, 1989

Honorable Jay Plager
Administrator
Office of Information and Regulatory Affairs
Office of Management and Budget
Old Executive Office Building
Room 246
Washington, D.C. 20503

Dear Mr. Plager:

I am writing to request that the Internal Revenue Service (IRS) modify and republish proposed regulation under Internal Revenue Code Section 89. The currently proposed rule vastly underestimates the paperwork and reporting burden of this law.

The policy goal of Section 89 of the 1986 Internal Revenue Code is to promote more equitable distribution of health (and life insurance) benefits, where the firm and its employees receive tax subsidies for the provision of those benefits. Section 89 sets the parameters for treatment of employer-sponsored fringe benefit plans under the Code to ensure that the tax subsidy for encouraging such plans is efficiently used, that is, that tax-subsidized benefits are equitably distributed and relatively close in value. In order to ensure compliance with Section 89 a number of collection requirements have been imposed on employers. This letter objects to IRS' estimates of burden hours imposed and asserts that the actual burden hours are many times more than IRS estimates.

The Paperwork Reduction Act of 1980 (44 U.S.C. 3504(h)), requires that the Internal Revenue Service publish and provide to the Director of the Office of Management and Budget an estimate of the compliance burden, both cost and time, that will result from the proposed regulations. Our comments, based on information derived from the Small Business Data Base, maintained by the Office of Advocacy of the Small Business Administration will demonstrate that the IRS has greatly underestimated the number of recordkeepers necessary to track information, the number of outside consultants that small firms will have to hire, and the number of hours that employers and the consultants they hire will have to spend to insure Section 89 compliance.

Our estimates of paperwork burden and compliance costs of Section 89 will address only the cost of compliance pertaining to health

benefits. Other fringe benefits, including life insurance and flexible spending accounts, undoubtedly will increase the burden of compliance and are not considered in our estimates.

Employers who offer health benefits are required to gather data about their firms, workforce characteristics, compensation and each health benefit option, including sworn statements as to the existence and content of spousal coverage elsewhere. These data are used for a complex set of tests to evaluate compliance with Section 89. If the benefit plan does not comply with section 89 requirements, the excess benefits must be shown on the W-2 forms of the highly compensated employees. Firms must also meet certain "qualification requirements" set forth in Section 89(k).

Recordkeepers

The IRS estimates that the annual recordkeeping and reporting burden that will result from the proposed regulations is 9,000,000 hours. 54 Fed. Reg. 9461 (March 7, 1989). This estimate is based on the assumption of 750,000 recordkeepers. Our data on the number of enterprises with employees in the United States, (1986) which does not include the self-employed, totals 3,850,221. Fifty-six percent of U.S. firms offer health insurance. Section 89 requires some recordkeeping functions for each firm with health benefits under Section 89. Therefore, we estimate the number of firms of whom compliance would be required is 2,122,513. We note that any firm that does not presently offer health care coverage may offer it during the year, which would increase the number of recordkeepers.

Compliance Cost

For this analysis, we have estimated costs based on employers with 10 - 24 employees. We have assumed that firms in this employment size bracket will have an employee, part-time usually, specializing in administrative recordkeeping. Smaller firms with fewer than 10 employees will face higher compliance costs since more owners' time will be involved, due to a lesser likelihood of a specialized recordkeeper, and more outside consultants will be utilized. Larger firms also will face higher costs of compliance with respect to those tests which require increasing compliance time as a function of the complexity of the organization and benefit plans, or the number of employees. Therefore, our estimates, based on the cost of compliance for firms with 10-24 employees, will underestimate total burdens because we have estimated costs for what we believe is the lowest cost size group, and because we have used a low estimate for the total number of firms in the universe. Overall, compliance burdens as determined by this office are considerably above those calculated by the Internal Revenue Service.

Our analysis of Section 89 data and testing requirements presumes that firms will require both outside consultants and internal recordkeepers. Many very small firms do not normally use

professional services, other than independent insurance agents, for health benefits. The complexity of data-gathering and testing, and the legal ramifications of noncompliance with all of Section 89, would require outside consultants, such as attorneys, accountants, and benefit consultants. We conservatively assess their time at approximately $75 per hour.

Because workforce characteristics, i.e. part-time workers, level of employee enrollment and choice of options in health care plans differ among employers, outside consultants will have to closely examine the data collected by employers and run compliance tests for each client firm. We estimate that consultants will spend approximately 31 hours on each plan for a total of $2325 in outside consultant fees per employer.[1]

In addition, we estimated that firms with 10-24 employees will expend about 41 hours internally at a cost of $30 per hour for a cost of $1230. Data required by Section 89 for determining compliance will compel internal collection of information by employers. Each employer must learn about the regulation, survey employees and establish internal communication systems, and review and input data from employee records and insurance records. We also estimated time for employees to complete sworn statements on the status of spousal coverage, and management time in administering the sworn statements.[2]

Once the tests are run and compliance is evaluated, excess benefits must be affixed to the highly compensated employee(s) W-2 forms. Our analysis has also allotted compliance time for reevaluating testing and data.

Approximately 406,048 firms (78 percent of firms in this category) with 10-24 employees have health insurance. Burden hours for this set would be 72 hours per firm (31 hours of consultant time at $75 per hour and 41 hours of employers time at $30 per hour), or 29.235 million hours for all firms of this set. The cost of compliance would total $3555 per firm, or $ 1.443 billion for all firms of this set. Assuming that costs

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[1]Time breakdown for professional services includes eight hours for review of data, five hours for testing and review of testing results, eight hours for legal review, ten hours accountant time for assessments of impact on highly compensated employees and W-2 forms.

[2]Time breakdown for internal time includes 12 hours for sworn statement completion by employees, five hours for administration of sworn statement, including communication to employees and collection, six hours for collection and review of data and insurance information, eight hours for in-house management review, two hours for W-2 changes, eight hours for reevaluation of data, testing, and results of professional services, as well as communication to employees.

per firm for firms in other size groups are the same (which, as discussed above, they are not), we estimate that a minimal estimate of overall burden is $7.543 billion

Regulatory Flexibility Act Compliance

The Regulatory Flexibility Act (RFA), 5 U.S.C. §601 et seq., requires the Internal Revenue Service to perform a regulatory flexibility analysis to ascertain the cost of compliance with proposed regulations on small business and, if possible reduce unnecessary burdens. The Regulatory Flexibility Act only applies to legislative (or substantive) rules and exempts interpretative rules from analysis. In this instance the IRS incorrectly construed the proposed regulation as interpretative and, therefore, did not prepare a regulatory flexibility analysis as required by the RFA.

Section 89 proposed regulations are not merely interpretive but result from legislative-like authority delegated by Congress through the Tax Reform Act. For example Prop. Reg. ss1.89(k)-1, Q&A 3(d)(4), 4(e), 5(g) (4), 6(f), which defers the effective date of several qualification requirements; Prop. Reg. ss1.89(a)-1, Q&A 4(d)(1) that statements regarding family status be made under penalty of perjury; and Prop. Reg. ss1.89(a)-1, Q&A 4(d)(2), that treats certain benefits attributable to salary reduction as not available to any nonhighly compensated employees all demonstrate the substantial discretion given to the IRS in its rulemaking activities. Therefore, we believe that the proposed rule is not interpretative and that IRS is required to prepare and publish a regulatory flexibility analysis. It is incumbent upon the IRS to properly characterize its proposed rule as other than interpretative and to publish a final regulatory flexibility analysis with the final rule.

A regulatory flexibility analysis would have been of great assistance to the Office of Management and Budget and the public in assessing the real burdens imposed by the Section 89 regulations.

Conclusion

The estimates of paperwork and recordkeeping burdens prepared by this Office are many times than those of the Internal Revenue Service. We believe that the IRS should republish this rule with a more reasonable approximation of paperwork compliance burden, as well as a regulatory flexibility analysis, in order to allow for more proper review.

Finally, I note that both the House and Senate tax writing committees are considering major changes to Section 89, and the Administration has stated its agreement that change is necessary. Notwithstanding our specific comments in this letter and the welcome announcement of Secretary Brady this week on postponement of certain rules until October 1, Treasury and OMB should

seriously consider withholding approval of this particular proposal given the great likelihood the law will soon be significantly changed and simplified.

Very truly yours,

Frank S. Swain

Frank S. Swain
Chief Counsel for Advocacy

		Employment Size of Firm				
	Total	1-9	10-24	25-99	100-499	500+
Number of Enterprises*	3,805,368	2,850,221	520,574	347,050	72,302	15,221
Number of Firms With Health Benefits+	2,122,513	1,311,102	406,048	319,286	70,856	15,221

* Data on number of firms (private, non-farm) and firm size categories from the U.S. Small Business Administration Office of Advocacy, Small Business Data Base--U.S. Establishment and Enterprise Microdata File (USEEM) 1986.

+The proportion of firms with health insurance in each size category, used to calculate the number of firms with health insurance, was based on a study prepared for the Office of Advocacy, Health Insurance Coverage Costs in Small and Large Businesses, ICF, Inc., April 15, 1987.

Statement of

The Associated General Contractors of America

Presented to the

Committee on Small Business

of the

United States Senate

on the Subject of

The Estate Valuation Requirements of Section 2036(c)

September 18, 1989

AGC is:

- More than 32,500 firms including 8,000 of America's leading general contracting firms responsible for the employment of 3,500,000-plus employees;
- 104 chapters nationwide;
- More than 80% of America's contract construction of commercial buildings, highways, industrial and municipal-utilities facilities.

The Associated General Contractors of America is a construction trade association representing more than 32,500 firms, including 8,000 of America's leading general contracting companies, which are responsible for the employment of more than 3,500,000 individuals. These member construction contractors perform more than 80% of America's contract construction of commercial buildings, highways, bridges, industrial and municipal-utilities facilities. AGC appreciates this opportunity to comment on the estate valuation freeze rules.

The construction industry is composed predominantly of small, family-owned firms competing in local geographic markets. Eighty-five percent of AGC's membership has gross receipts of less than $10 million annually; ninety percent qualify under the Small Business Administration's definition of a small business.

AGC supports proposals to repeal Section 2036(c), the estate valuation rules. Section 2036(c) was added to the Internal Revenue Code without any hearings and with little advance notice. It penalizes small family businesses which is the sector of the American economy that generates the most innovation, as well as the most new jobs. It makes it harder for owners of business who have spent a lifetime building up a business, to transfer the business to the next generation or to employees without being subjected to confiscatory taxation.

HISTORY

A parent or member of an older generation wishes to motivate the children or members of a younger generation to join or stay in the family business. The parent may also wish to ensure that at the parent's death, the level of equity in the company permits the next generation to raise sufficient money to buy it or to pay estate taxes on it. The parent may also wish to ensure a steady retirement income.

Under prior law, the parent would cause the company to recapitalize and create two new classes of stock. A preferred stock class would be created for the parent. The parent would receive a fixed income from the preferred stock after building up the company and retain some interest in the company's continuation. A common stock class would be created for the next generation. It would appreciate in value as the company appreciated. The next generation would reap the benefits of working to ensure the continuation and growth of the family business. The equity of the business could stay in the business. The value of the business in the parent's estate would be "frozen" at the preferred stock level.

The Revenue Act of 1987 added Section 2036(c) to the Code. If an individual holds a substantial interest in an enterprise and after December 17, 1987, "in effect transfers property having a disproportionately large share of potential appreciation in the enterprise while retaining an interest in the income of, or rights in the enterprise," the retention of that interest is considered a retention of the enjoyment of the

transferred property. The value of the transferred property comes back into the parent's estate.

Section 2036(c) eliminated the traditional corporate and partnership estate freezing techniques. As originally enacted Section 2036(c) went far beyond those basic transactions. It also covered a variety of other everyday business transactions. The 1988 Tax and Miscellaneous Revenue Act (TAMRA) amended Section 2036(c). The act added several safe harbors, but it also added a "deemed gift" rule. Congress also granted the IRS unusually broad authority to write regulations in this area and to expand the types of distributions to which it applies. IRS Notice 89-99, published on September 1, 1989, gave the first guidance on how the IRS intends to enforce the statute.

PROBLEMS WITH SECTION 2036(c)

The broad statutory language contained in Section 2036(c) makes estate planning and orderly business succession very difficult. The IRS's broad ability to interpret the statute means that taxpayers may carry out a transaction that is not subject to Section 2036(c) when it is designed, but the IRS may decide several years later that the transaction is actually subject to Section 2036(c).

Section 2036(c) as presently interpreted by the IRS applies not only to transfers of interest in a business but transfers of passive investments as well. For example, if

a parent transfers a bond to a child but retains the right to the interest payments, that transaction is subject to Section 2036(c).

The "safe harbors" created by TAMRA are helpful, but the guidelines recently issued by the IRS demonstrate the difficulties involved in fitting into the safe harbors. There is also a risk that transactions not strictly following the narrow safe harbors will be treated as being subject to Section 2036(c) by the IRS.

The IRS issued the first preliminary guidance on Section 2036(c) on September 1, 1989. IRS Notice 89-99 provides some guidance to taxpayers, but leaves many issues unresolved. Taxpayers facing a deadline of January 1, 1990 must make essential decisions without adequate guidance.

Transfer. Section 2036(c) applies if an individual "in effect transfers" property. That phrase is extremely vague. IRS Notice 89-99 states that it includes the creation of trusts, intra-family sales (including installment sales, private annuities and sales of remainder interests), transfer and leaseback arrangements and joint purchases of income and remainder interests. Transfers may include gifts, sales or trades of property.

"Potential Appreciation." Neither the legislative language nor the notice defines "potential appreciation" or explains how to estimate it. IRS Notice 89-99 established an extremely broad test. The taxpayer is required to assume that any combination of

circumstances that would maximize the potential appreciation of the interest would take place.

"Enterprise." Section 2036(c) applies to the transfer and retention of interests in an "enterprise." The legislative language does not define enterprise, but the conference report states that it includes a business "or other property which may produce income or gain." The definition is extremely broad and creates a great deal of uncertainty as to what transactions are covered.

The recent IRS notice states that Section 2036(c) covers passive investment activity as well as the operation of a business entity. Until the guidance was issued, life insurance policies and sales of personal residences were believed to be covered by Section 2036(c). The clarification on those two issues is helpful, but it also indicates the confusion surrounding the scope of Section 2036(c).

Deemed Gift. TAMRA also added a type of gift tax provision to Section 2036(c). Its operation can be seen in the following example:

- Parent transfers common stock to Child and keeps preferred stock (placing transfer within the scope of Section 2036(c)).

- Child transfers common stock to Partner (who is not a member of Parent's family).

- Parent is now treated as making a gift of the common stock to Child.

- Parent later transfers the preferred stock and is again treated as having made a gift.

Sale to Family Member. Generally, Section 2036(c) does not apply to a transaction if the individual receiving the asset pays fair market value for it. However, Section 2036(c) states that its rules apply on sales to family members, even if the family member pays fair market value for it. If the parent retains an interest in the business or asset, the asset that was sold will be included in the parent's estate.

The only exception is if the family member purchaser can prove that he or she had enough money from other than family sources to purchase the assets. Income from gifts the parent has given the child would not be considered an "outside" source of money.

Sale to Employees. If the owner transfers an interest in the business to employees, but retains rights in the business, Section 2036(c) would come into play. The IRS notice clarifies that if the transfer is for fair market value, then Section 2036(c) can be avoided. However, the owner may not give the employees more favorable terms than would be given to strangers.

CONCLUSIONS AND RECOMMENDATIONS

AGC believes incentives for entrepreneurship and capital growth are vital for a healthy, growing and competitive economy. To foster competitive and innovative businesses, which in turn provide economic growth and jobs, tax policy must provide incentives for hard work and entrepreneurship. Section 2036(c) penalizes family businesses by making it more difficult for them to survive financially the transfer of ownership. It penalizes efforts to encourage younger generations to join the business, and discourages efforts to sell the business to company employees.

For small businesses to thrive, the founders need to leave capital in the business. In the construction industry, insurance and bonding capability are directly impacted by the business's capital structure. Construction contractors must leave equity in the business to ensure adequate bonding capacity so that they and their successors may bid on jobs.

Not only does Section 2036(c) affect orderly succession planning, it affects the basic viability of the business. If equity is taken out of the construction company, its bonding capacity is reduced. The founder may die and leave so much valuable equity in the business, the next generation cannot raise enough money to buy the business or pay the estate taxes on it. The business would have to be sold to pay the estate taxes.

This is particularly inequitable when the next generation has been working to build the business. At least part of the buildup of the business has been due to their efforts. As the construction company grows, the increased equity left in the business will make it that much harder for the next generation to take it over. However, under Section 2036(c), the next generation is so hampered by constraints that it often makes economic sense for them to work elsewhere than to stay with the business.

Individuals need incentives to take risks. One of the incentives in forming a family business is the opportunity to pass something on to the next generation. Without incentives, the financial risks that must be faced early in the business's formation are not worthwhile.

The interaction of the estate valuation rules with the other recent tax code changes are hurting small businesses. For example, the 1986 Tax Reform Act repealed the General Utilities doctrine. Previously, a single tax was paid at the shareholder level on liquidating sales and distribution of a business. The proceeds were not taxed at the corporate level. Under current law, if the owner retires and liquidates the business, the double taxation reduces the amount the owner will realize on the sale of the business.

The proceeds from the sale of the company are further reduced by the repeal of preferential tax treatment for long term capital assets. The 1986 Act's repeal of

preferential treatment for capital gains means that an owner that had invested for the long term instead of spending for the short term is penalized.

The 1988 tax act further reduced the ability of the owner to sell the company to employees or third parties. Sales of property are restricted in their use of the installment sales method of reporting income.

Tax changes proposed this year, if passed, will make it even harder for the owner to transfer the business to its employees. Under current law, when an ESOP borrows funds to acquire company stock, certain financial institutions may exclude from taxable income 50% of the interest earned on a loan to a qualified ESOP. If an estate's executor sells the decedent's stock to the company's ESOP, up to 50% of the sale proceeds are excluded from estate taxes. HR 3150 would repeal both those provisions, making it harder for a company's ESOP to obtain financing and reducing the incentives to sell a company to an ESOP.

In effect, the tax code penalizes the owner of a business at the end of his or her career no matter how the transfer is accomplished or to whom the business is sold.

When these provisions are taken together with the estate freeze rules, the consequences to small family businesses are very severe. Owners of construction companies who have taken financial risks and who have devoted a lifetime to building

equity in a business and who transfer it to the next generation, transfer it to employees or even sell it to strangers cannot dispose of that business at the close of their careers without being subjected to confiscatory tax rates. This is a great disincentive to entrepreneurship and penalizes investment. AGC believes the most innovative and productive sector of the economy deserves better. AGC recommends that Section 2036(c) be repealed.

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